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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 34

FEDERAL POWER COMMISSION, CITY OF AKRON AND
PENNSYLVANIA PUBLIC UTILITY COMMISSION,
PETITIONERS

v.

HOPE NATURAL GAS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the Circuit Court of Appeals is officially reported in 134 F. (2d) 287, and may be found at R. IV, 169-207.¹ The opinion of the Federal Power Commission is reported in 44 P. U. R. (N. S.) 1, and may be found at R. I, 4-89.

¹In the record citations, roman numerals refer to the volume and arabic numerals to the page.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 16, 1943 (R. IV, 207). The petition for a writ of certiorari was filed on April 6, 1943, and was granted on May 17, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. § 347), and Section 19 (b) of the Natural Gas Act (15 U. S. C. § 717r).

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act (52 Stat. 821; 15 U. S. C. § 717) are set forth in Appendix A, pp. 124-135.

QUESTIONS PRESENTED

The Federal Power Commission, acting pursuant to the Natural Gas Act, after complaints by the Cities of Cleveland and Akron and the Pennsylvania Public Utility Commission, and after extensive hearings, found that the interstate rates of Hope Natural Gas Company were unreasonable and unlawful and issued an order reducing the Company's future rates by \$3,609,857 annually. The Federal Power Commission adopted a "prudent investment" rate base. The circuit court of appeals invoked the "present fair value" theory to set aside the Commission's findings and order. The questions presented are:

1. Whether, for rate-making purposes under the Natural Gas Act, the Commission is author-

ized to use a rate base determined exclusively upon the basis of prudent investment measured by "actual legitimate cost" less depreciation,² or whether it must use a rate base which reflects estimates of the extent and effect of post-investment fluctuations in labor and material prices.


2. Whether the Commission must include in "actual legitimate cost" amounts previously and correctly charged to operating expenses, in accordance with industry practice of the time, and determined by the Commission to have been recouped through revenues received from rate payers.

3. Whether the Commission may determine actual existing (accrued) depletion and depreciation and the annual allowance in operating expenses for these factors, upon the basis of "actual legitimate cost," or whether the Commission must base such determinations upon estimates of the "present fair value" of the property.

4. Whether the court below erred in holding that in determining the actual existing (accrued) depletion and depreciation, the Commission failed to take into account "the present condition of the property."

² "Actual legitimate cost" (which Section 6 (a) of the Natural Gas Act authorizes the Commission to ascertain for natural-gas companies) less existing depreciation has been interpreted by the Commission to be "prudent investment." *Re Canadian River Gas Company*, 43 P. U. R. (N. S.) 205; *Detroit v. Panhandle Eastern Pipe Line Co.*, 45 P. U. R. (N. S.) 203; see *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263.

MICRO CARD

TRADE MARK 

22

43

2101



63



5. Whether the "economic-service-life" principle, as applied by the Commission in this case, is a reasonable method of determining the actual existing depletion and depreciation and the annual allowance therefor.

6. Whether the court below erred in holding that \$165,963 for an experimental deep-test well, which was completed dry and charged to operating expenses in 1941, should have been included in 1940 operating expenses.

7. Whether the rates fixed by the Commission are just and reasonable in the statutory sense and nonconfiscatory in the constitutional sense.

8. Whether the Commission has jurisdiction to determine the *lawful* rates for interstate sales of natural gas at wholesale after the effective date of the Natural Gas Act of 1938 and prior to the issuance of a Commission rate-fixing order.

9. Whether the court below erred in holding that the Commission's "findings as to past rates * * * should be set aside."

STATEMENT

THE COMPANY

Hope Natural Gas Company ("Hope"), a wholly owned subsidiary of the Standard Oil Company (New Jersey), is conceded to be a "natural-gas company" within the meaning of the Natural Gas Act (R. III, 19). Hope purchases and produces natural gas in West Virginia, transports it in pipe lines to the West Virginia-Ohio

and West Virginia-Pennsylvania state lines, and there sells it in interstate commerce to its affiliates, East Ohio Gas Company and River Gas Company, for resale to ultimate consumers in Ohio; to its affiliate, Peoples Natural Gas Company, for resale to ultimate consumers in Pennsylvania; and to the nonaffiliated Manufacturers Light and Heat Company and Fayette County Gas Company for resale in Pennsylvania (R. I, 17). About 80% of Hope's total sales are in interstate commerce and 95% of such sales are to its aforementioned affiliates (R. I, 18). About 20% of Hope's total volume of gas is sold in intrastate commerce to local consumers in West Virginia. Hope has been purchasing, producing, transporting, and selling natural gas for more than forty years. Hope's interstate sales in 1940 amounted to about 53,000,000 MCF, and its interstate gross revenues in that year amounted to \$19,296,755. (R. I, 51.)

Hope's only outstanding securities since its inception have been in the form of common stock, now having an aggregate par value of approximately \$28,000,000. During the four decades of its operations, Hope has paid more than \$108,000,000 in dividends, including \$11,000,000 in stock dividends. The average annual yield on the average annual amount of Hope's capital stock issued for cash or other assets has exceeded 20%. (R. III, 15.) Hope's balance sheet at the end of 1938 showed a net investment, per books, in the entire

gas plant of approximately \$15,500,000;³ an investment in Government bonds of \$11,000,000 and cash and investments of \$5,500,000 (R. III, 21-24).

THE STATUTE

The Natural Gas Act, effective June 21, 1938 (the "Act"), requires that all rates or charges by natural-gas companies in connection with the transportation or sale of natural gas subject to the Act be just and reasonable, and declares any rate or charge that is not just and reasonable to be unlawful (Sec. 4 (a)). It provides that the Federal Power Commission, upon complaint of any State, municipality, State commission, or gas distributing company, or upon its own motion, whenever it finds that any rate is unjust or unreasonable, shall determine the rate to be thereafter observed and in force, and shall fix the same by order; and, further, that the Power Commission "may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates" (Sec. 5 (a)). Any State, municipality or State commission may file a complaint with the Power Commission, complaining of anything done or omitted to be done by any natural-gas

³ Prior to 1938 Hope had transferred \$7,500,000 from the depletion and depreciation reserves to earned surplus (R. I, 19, Ex. 61; R. III, 176-179). An adjustment to account for that transfer would reduce the \$15,500,000 net investment per books shown as of 1938 to about \$8,000,000.

company in contravention of the provisions of the Act (Sec. 13).

Under Section 14 (a) the Power Commission may investigate any matter "to determine whether any person has violated or is about to violate any provision of this Act" and may "make available to State commissions and municipalities, information concerning any such matter". Section 16 authorizes the Power Commission to perform any and all acts it may find necessary or appropriate to carry out the provisions of the Act. And Section 17 (c) requires the Power Commission to make available to the several State commissions "such information and reports as may be of assistance in State regulation of natural-gas companies".

PROCEEDINGS BEFORE THE COMMISSION

In July 1938, the Cities of Cleveland and Akron filed complaints with the Power Commission charging that the rates collected by Hope from East Ohio Gas Company ("East Ohio") were excessive and unreasonable (R. II, 1, 7). In October 1938, the Power Commission, on its own motion, instituted an investigation to determine the reasonableness of all of Hope's interstate rates (R. II, 28). In March 1939, the Pennsylvania Public Utility Commission filed a complaint with the Power Commission, charging that the rates collected by Hope from Peoples Natural Gas Com-

pany, Manufacturers Light and Heat Company, and Fayette County Gas Company were unreasonable (R. II, 18). The City of Cleveland's complaint, as amended and modified, prayed specially for a determination by the Power Commission that Hope's collected rates from East Ohio were unreasonable and therefore unlawful, and for a determination of just and reasonable Hope-East Ohio rates from June 30, 1939, to the date of the Power Commission's decision, requesting such determinations "in the aid of State regulation" and particularly to afford the Public Utilities Commission of Ohio a proper basis for disposition of a fund collected by East Ohio under bond from Cleveland consumers during the period since June 30, 1939 (R. II, 14).⁴

⁴ The fund represents the difference between East Ohio's previous rates and the lower rates established by ordinance of the City of Cleveland, which East Ohio is collecting pending its appeal from the ordinance to the Public Utilities Commission of Ohio, under §§ 614-644 *et seq.* of the Ohio General Code. See *Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, 317 U. S. 456, 463.

Representing that the Ohio Commission's determination of the reasonableness of the retail rate established by the City of Cleveland for sales by East Ohio to Cleveland consumers, for the years in which the fund was accumulated, "was ultimately dependent upon the lawfulness" of Hope's wholesale charge to East Ohio (R. II, 45), the City in its amended complaint of January 6, 1939, had requested the Power Commission to determine the lawful wholesale rates from and after June 21, 1938, to the effective date of its order fixing Hope's rates. In a brief subsequently filed before the Power Commission, the City limited the request to cover rates

In October 1939, the Power Commission consolidated for hearing the three complaint cases and its own investigation of Hope's interstate wholesale rates (R. II, 34). Hearings were held in 1940³ and 1941, and after briefs were filed, the case was argued orally before the Power Commission sitting *en banc* on October 27, 1941 (R. II, 48). The Commission decided the case on May 26, 1942, when it entered an "Order Reducing Rates" charged by Hope and, in addition, separate "Findings as to Lawfulness of Past Rates" collected by Hope from East Ohio (R. I, 1, 8).

THE COMMISSION'S DETERMINATIONS

The Commission's "Order Reducing Rates" required Hope to reduce its interstate rates for the future to reflect a reduction of not less than \$3,609,857 in operating revenues on an annual basis (R. I, 6). More particularly, the order re-

charged from and after June 30, 1939, for the reason that a settlement had made the question moot with respect to the earlier period originally covered.

³ On December 20, 1940, the Power Commission denied without prejudice a motion of the Cities of Cleveland and Akron for an immediate order reducing the Hope-East Ohio rates upon Hope's own testimony, for the reason that "there is insufficient evidence of record, at this time, to support the prayer for relief requested by the movants," and subject to the reservation that "this order is not to be construed as a determination of any of the issues in the pending principal proceedings" (R. II, 43).

quire minimum reductions of 7 cents per MCF from the 36.5¢ and 35.5¢ rates previously charged East Ohio and Peoples Natural Gas Company, respectively, and 3 cents per MCF from the 31.5¢ rate previously charged Fayette County Gas Company and Manufacturers Light and Heat Company (R. I, 73-74). The Commission's "Findings as to Lawfulness of Past Rates", made in deciding the complaint of the City of Cleveland, determined that the rates collected by Hope from East Ohio were unjust, unreasonable, excessive, and therefore unlawful, by \$830,892 in 1939, \$3,219,551 during 1940, and \$2,815,789 on an annual basis since 1940; and further determined just and reasonable rates for gas sold to East Ohio for resale for ultimate public consumption to be \$11,528,608 for 1939, \$11,507,185 for 1940, and \$11,910,947 on an annual basis for 1941 and the first half of 1942 (R. I, 12-13).

The Commission founded its "Order Reducing Rates" upon a rate base of \$33,712,526, upon which it granted Hope a 6½% rate of return, or \$2,191,314 annually (R. I, 4). This rate base was determined to be the actual legitimate cost of Hope's interstate property less existing depletion and depreciation, plus allowances for unoperated acreage, working capital, and future net capital additions (R. I, 50).

The Commission's rate base was arrived at substantially as follows: The Commission found

that Hope had kept complete documentary evidence, through books, records, and vouchers, of its expenditures throughout its existence, so that no estimates were required to ascertain the actual legitimate cost of its property (R. I, 23, 174). Pursuant to a check of the inventory of Hope's property in service, and pursuant to an examination, analysis, and audit of Hope's records, the Commission determined the cost to be \$71,937,416 as of December 31, 1940, for the property devoted to interstate sales (R. I, 3, 50). From this amount, the Commission deducted accrued depletion and depreciation, which it found to be \$22,328,016 (R. I, 4, 45, 50).⁶ It arrived at this figure by applying the "economic-service-life" method to actual legitimate cost (R. I, 41). In making these determinations the Commission was guided by a study conducted by a qualified staff engineer, who made a field inspection of Hope's physical properties to aid in the determination of service lives (R. I, 42; R. III, 158). To the cost, less accrued depletion and appreciation, the Commission then

⁶ The actual existing depletion and depreciation found by the Commission came to about \$24,000,000 less than the depletion and depreciation of some \$46,000,000 which the Company had accrued on its books (R. I, 81). One of the Commissioners dissented on the ground that the Commission should have deducted from actual legitimate cost, accrued depreciation and depletion of not less than \$38,000,000, the reserve remaining on the Company's books after it had transferred \$7,500,000 from that reserve to surplus (R. I, 81). See n. 3, p. 6, *supra*.

added \$1,392,021 for future net capital additions, \$566,105 for useful unoperated acreage, and \$2,125,000 for working capital, yielding the total rate base of \$33,712,526 (R. I, 50).

Using 1940 as a test year to forecast future revenues, and forecasting expenses at the 1940 figure plus \$421,160, the Commission allowed Hope operating expenses and taxes amounting to \$13,495,584 (R. I, 5, 65). Of this total \$1,460,037 represented the annual allowance for depreciation and depletion (R. I, 53, 65). This allowance was determined by the Commission in the same way as the actual existing depreciation and depletion, by the application of the "economic-service-life" method to the actual legitimate cost of Hope's properties (R. I, 51-52).

The Commission's "Findings as to Lawfulness of Past Rates" were arrived at on the same principles and in substantially the same manner as the "Order Reducing Rates," except that they were based on actual operating experience for the years in question, instead of a test year (R. I, 11).

In issuing its order and findings the Commission rejected Hope's argument that post-investment changes in price levels had to be reflected in the rate base and in computing both accrued depreciation and depletion and the annual allowance in operating expenses for these items (R. I, 20-23, 36, 41, 52). It condemned as hypothetical and without probative value the "reproduction cost new" and "trended original cost" estimates

(amounting to approximately \$97,000,000 and \$105,000,000, respectively) submitted in evidence by Hope in support of its claimed rate base of some \$66,000,000 (R. I, 20-23). The Commission also rejected Hope's contention that, in any event, the rate base should have reflected an additional sum of about \$17,000,000, largely representing expenditures for well-drilling prior to 1923 which Hope had charged to operating expenses (R. I, 24-34). Likewise unsuccessful was Hope's argument for adopting the "percent condition" theory of measuring accrued depreciation (R. I, 38).

Pursuant to Section 19 of the Act, Hope filed an application for rehearing (R. II, 51), and upon denial petitioned the United States Circuit Court of Appeals for the Fourth Circuit for a review of the Commission's "Order Reducing Rates" and the Commission's "Findings as to Lawfulness of Past Rates" (R. IV, 3).

DECISION OF THE CIRCUIT COURT OF APPEALS

On review, the court below, with one judge dissenting, set aside the Commission's "Order Reducing Rates" on the basic grounds that: (1) the Commission's use of a prudent investment rate base failed to reflect "present fair value," in view

Hope did not seek a stay of the Commission's order from the Circuit Court of Appeals and such order has not been stayed; instead Hope agreed with its customer companies to charge the ordered rates pending litigation, upon the customers' agreement to make Hope whole if the Commission's order should be finally invalidated.

of the post-investment "decided change" in price levels shown by the record and by judicially noticeable facts (R. IV, 172, 183-184); (2) the Commission erroneously excluded from the rate base the well-drilling costs previously incurred and charged to operating expenses prior to 1923 (R. IV, 172, 184-189); (3) the Commission improperly determined accrued depreciation on the basis of "theoretical formulas," without considering the present physical condition of Hope's property (R. IV, 172, 189-190); (4) the Commission should have based its annual allowance in operating expenses for depreciation and depletion upon the "present fair value" of the physical property, instead of upon actual legitimate cost (R. IV, 194-198); (5) the Commission should have included in 1940 operating expenses \$165,963 for an experimental deep-test well, which was completed dry and charged to operating expenses in 1941 (R. IV, 198); (6) the Commission should have made an annual allowance for depreciation and depletion on capital added to the rate base after 1940 (R. IV, 196).

The court below also set aside the Commission's "Findings as to Lawfulness of Past Rates," holding that: (1) the Commission had no jurisdiction to make findings as to lawfulness of past rates "to be given effect in rate proceedings before state commissions," and that rates filed with the Commission under Section 4 (c) of the Act became the

only "lawful" ones which Hope could charge or accept until changed by the Commission; (2) the Commission could investigate "the conditions and rates of the past" as an incident of its power to fix future rates, but that so viewed the findings in question were invalid for the same reasons as its "Order Reducing Rates," and were also objectionable in that they were based on actual experience for the years in question, rather than reasonable estimates of expense based on experience during a prior period (R. IV, 200, 202).⁸

SUMMARY OF ARGUMENT

I

In judicial review under the Natural Gas Act the statutory and constitutional standards coalesce. As there is no question here of the adequacy of the Commission's procedure or the existence of evidence to support its basic findings, the question is whether its order, as applied to the facts before it and viewed in its entirety, produces an arbitrary result. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 586. Thus tested, the order is clearly valid. The prescribed rates are plainly not arbitrary in the light of the financial history of the Company,

⁸ On March 8, 1943, the court below granted a motion for the stay of its mandate pending further order, upon the condition that a petition for writ of certiorari be filed with the Supreme Court of the United States within thirty days (R. IV, 209). The petition was filed on April 6, 1943.

which discloses, through the payment of dividends and the accumulation of earned surplus, that it has earned the total investment in the Company nearly seven times over. If the Company's proffered rate base were accepted, its average rate of return during the preceding several years would have been only 3.27 per cent; so modest a rate, without protest, suggests an inflation of the rate base claimed. *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U. S. 290, 311, 312; *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151. Moreover, many doubtful items were resolved in favor of the Company, which aggregate over \$26,000,000 in terms of the rate base, and more than \$600,000 in terms of annual operating expenses; and the rate of return, 6½ per cent, is a generous one. The actual experience of the Company under the prescribed rates provides reassurance that in fact they were liberal. We turn, nevertheless, to a consideration of the component determinations made by the Commission which were reviewed and set aside by the court below.

II

The Commission properly used prudent investment to determine the rate base. It found the base to be \$33,712,526, calculated to be the actual legitimate cost of gas plant in service less accrued depletion and depreciation plus net capital

additions through 1943, unoperated acreage and working capital.

The statute clearly contemplates that the Commission should give primary if not exclusive emphasis to prudent investment, if constitutionally possible. There is, we submit, no constitutional barrier. The so called rule of *Smyth v. Ames*, requiring a fair return on the "present fair value" of the property, is unsound and unworkable. It is based on the eminent domain principle of just compensation for a taking of property, a principle which is inapposite to regulation. Criticism of the doctrine by informed sources has been persistent and weighty. On the basis of long experience, virtually all informed opinion is agreed that effective rate regulation on a fair-value basis is a practical impossibility and that the standard of prudent investment is sound in principle and eminently workable, is just to consumers and to investors, and will attract sufficient capital to secure adequate service.

The view of the court below, that price trends must be taken into account, would introduce in another way the same irrelevancies and uncertainties which have led to the breakdown of the present-fair-value rule. There should be no compulsion upon the Commission to employ formulas of that sort. If price trends are relevant as bearing upon stability of investment, this factor can be taken into account in determining the permitted rate of return.

III

In determining actual legitimate cost or investment, the Commission correctly refused to include in the rate base \$17,000,000 representing largely intangible costs of well drilling properly charged to operating expenses before 1923. The Commission found that it was the accepted practice at the time for the industry to charge well-drilling expenditures to expense, that Hope deliberately and correctly accounted for such items as operating expenses, and that well-drilling expenditures had been contemporaneously recovered through revenues from the rate payers. In accordance with the overwhelming weight of authority, the Commission, although it was willing to and did correct genuine accounting errors, refused to include in the investment base the amounts previously and properly charged to operating expenses. To have included such amounts would have taken multiple exactions from the rate payers by compelling them to pay a return and an annual allowance for depreciation on the money they had already paid to the utility. The utility has no existing capital investment in the well-drilling costs for which the rate payers have reimbursed the Company, and is not entitled to a return on capital invested by its rate payers.

IV

The Commission properly used the economic-service-life principle in determining accrued de-

preciation. This principle embodies a consideration of the present physical condition of the property as well as a consideration of the functional causes of depreciation. By returning the full original investment, the method used is fair to the utility, investors, and consumers. The Commission's practice is one which has been analyzed and approved by this Court. *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 167, 168. The method has likewise been approved by the Interstate Commerce Commission, the Bureau of Internal Revenue, and most utility commissions. Moreover, the amount deducted by the Commission for accrued depletion and depreciation was about \$24,000,000 less than the amount which the Company had accrued on its books for depletion and depreciation.

V

The Commission properly used prudent investment as a base in determining the annual allowance for depreciation and depletion. The rates of depreciation and depletion were based on the economic-service-life principle and were thus correlated with the accrued depreciation and depletion. The rates were applied to the actual cost of the property. Under the decision of this Court in the *Natural Gas Pipeline* case, *supra*, a wasting asset business of limited life, such as the enterprise here involved, is in no event constitutionally entitled to no more than a return of its

actual legitimate cost of plant at the end of the economic life of the property. Any additional return would require the rate-payers to contribute to the capital of the company. See *Lindheimer v. Illinois Bell Telephone Co.*, *supra*, at 169. The method applied by the Commission is that universally recommended and followed by business enterprises, economists, accountants, and state and regulatory agencies.

VI

Hope was not harmed by the exclusion from the operating expenses for 1940 of an experimental deep-test well completed in 1941, since the future allowance for that purpose was more than large enough to absorb any possible errors in accounting for the test year.

VII

In aid of state regulation the Commission exercised its broad investigatory and fact-finding powers to determine the extent to which Hope's interstate wholesale rates were unjust and unreasonable and therefore unlawful for the years 1939, 1940, 1941 and the first half of 1942. It is doubtful that these findings are here reviewable. See *United States v. Los Angeles & S. L. R. Co.*, 273 U. S. 299, 309, 310. There was, however, authority to make the findings despite the lack of reparation power. Cf. *Atlantic Coast Line v. Florida*, 295 U. S. 301. Resort to such authority

promotes the Congressional purpose of an efficient and harmonious dual system of rate regulation. *Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, 317 U. S. 456, 467. The findings, like the order prescribing future rates, are supported by evidence.

ARGUMENT

I

VIEWED IN ITS ENTIRETY, THE COMMISSION'S ORDER PRESCRIBING RATES COMPLIES WITH THE STATUTORY REQUIREMENTS AND IS NOT CONFISCATORY

A. SCOPE OF JUDICIAL REVIEW

The Natural Gas Act and the decisions of this Court prescribe the division of functions between the Commission and the courts reviewing its rate orders. Section 19 (b) of the Act, conferring jurisdiction upon the circuit courts of appeals to review orders of the Commission, accords finality to the Commission's findings "as to the facts, if supported by substantial evidence." This fits within the general pattern of recent Congressional policy, revealed in other statutes, to entrust specialized agencies with the functions of appraising conflicting evidence, measuring the weight and credibility of testimony, and finding the facts. *Opp Cotton Mills, Inc. v. Administrator*, 312 U. S. 126, 154; *N. L. R. B. v. Link-Belt Co.*, 314 U. S. 584, 597; *Rochester Tel. Corp. v. United States*, 307 U. S. 125, 146; *Federal Trade Commission v.*

Algoma Co., 291 U. S. 67, 73. In this aspect, the judicial inquiry on review of the Commission's order is limited to whether a fair hearing was afforded the Company and whether there is substantial evidence to support the Commission's findings of fact. *St. Joseph Stock Yards Co. v. United States*, 298 U. S. 38, 51; *Interstate Commerce Commission v. Louisville & Nashville R. R.*, 227 U. S. 88, 91; *Virginia Ry. Co. v. United States*, 272 U. S. 658, 663; *Tagg Bros. & Moorhead v. United States*, 280 U. S. 420, 444; *Florida v. United States*, 292 U. S. 1, 12.

No question was raised below as to the finality of the Commission's factual findings, or as to the meeting of all procedural requirements. The court below did not hold that any of the Commission's findings, whether basic or ultimate, were not supported by substantial evidence; the record in fact contains substantial evidence to support each basic and ultimate finding made by the Commission.^{8a} The court below likewise did not hold that Hope was denied a fair hearing; and here again the record clearly establishes the contrary. The Commission's order of October 3, 1939, fixing the date of the hearing, set forth all the issues involved and, pursuant to the Commission's rules

^{8a} For example, original cost: R. I, 225-341; R. III, 25-81. Depreciation: R. I, 373-390; R. III, 25-81, 175-201. Rate of return: R. III, 224-365, 397-489. Working capital: R. III, 211-224. Income, allocation of costs of service: R. III, 224-365.

of practice, prescribed the procedure for Hope "to open and close these proceedings with the presentation of its evidence"⁹ (R. II, 34-36). At the hearing, Hope was afforded and availed itself of full opportunity to present its evidence, to cross-examine witnesses, to test, explain or rebut evidentiary facts, to present briefs and oral argument, and otherwise to be heard on all the issues involved.¹⁰

Apart from the questions of procedural requirements and factual sufficiency, there remain solely the issues of whether the rates prescribed by the Commission are "just and reasonable" under the Act, and whether they violate any constitutional precepts of fairness. Rate-making orders must face in the courts the scrutiny to which administrative and regulatory orders of Government agencies in other fields are subjected (cf. *Gray v. Pow-*

⁹Sec. 50.63 of the Commission's Provisional Rules of Practice and Regulations under the Natural Gas Act.

¹⁰There were forty-three days of hearing, at which a comprehensive record of more than 14,000 pages of exhibits and testimony was produced and during which Hope presented its case-in-chief, cross-examined Commission witnesses, and presented rebuttal and surrebuttal testimony. Main and reply briefs were filed by Hope and by the other parties to the proceedings; these briefs included requested findings in great detail, both basic and ultimate, relating to all subjects involved in the proceedings. Oral argument was presented by Hope's counsel to all five members of the Commission on October 27, 1941. After the Commission issued its opinion and order fixing rates, Hope filed an extensive petition for rehearing and stay of the order.

ell, 314 U. S. 402; *South Chicago Coal & Dock Co. v. Bassett*, 309 U. S. 251), but there is no reason to require that they run any more formidable gauntlet.¹¹ In this aspect—the statutory and constitutional standards being substantially the same—the true test is whether “the limits of due process” have clearly been overstepped, and whether “the Commission’s order, as applied to the facts before it and viewed in its entirety,” produces an arbitrary result. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 586. But in condemning the rates prescribed by the Commission, the court below did not view the Commission’s order “in its entirety” in order to determine whether it produced unreasonable or confiscatory results. The court rather concerned itself with particular determinations of the Commission, contrary to the repeated pronouncements of this Court that the result of the rate fixed, not the method employed, is determinative (*West Ohio Gas Co. v. Public Utilities Commission*, 294 U. S. 63, 70; *Railroad Commission v. Pacific Gas & Electric Co.*, 302 U. S. 388, 394), and that the courts may not interfere unless the complaining party clearly establishes that the pre-

¹¹ See Black, Douglas, and Murphy, J. J., concurring in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 608; Frankfurter, J., concurring in *Driscoll v. Edison Light & Power Co.*, 307 U. S. 104, 122; Brandeis, J., concurring in *St. Joseph Stock Yards Co. v. United States*, 298 U. S. 38, 78-82.

scribed rates are confiscatory. *Los Angeles Gas Co. v. Railroad Commission*, 289 U. S. 287, 305; *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 169; *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U. S. 290, 298; *St. Joseph Stock Yards Co. v. United States*, 298 U. S. 38, 53.

BE VIEWED IN THEIR ENTIRETY, THE COMMISSION'S PRESCRIBED
RATES ARE PLAINLY NOT ARBITRARY

As shown hereinafter (pp. 33-49, 70-109), the Commission's rate order adequately meets even the supererogatory criteria adopted below. It is even clearer, however, that the Commission's results, when viewed in their entirety, meet every test of reasonableness and fall far short of confiscation.

1. *Hope's financial history*

The total rate reductions ordered by the Commission amounted to a decrease of about \$3,600,000 in annual operating revenues (R. I, 6). The impact of this reduction upon Hope must be appraised against the background of the Company's financial history. From the time of its incorporation in 1898 through 1940, Hope's total issue of capital stock for cash or property has been about \$17,000,000 (R. III, 7). On this investment, Hope has paid dividends of over \$108,000,000 and has accumulated an earned surplus of over \$8,000,000—thus earning its total investment in the Company

nearly seven times over.¹² During its entire business life, down to 1940, Hope has earned an average of more than 20% per year on the average annual amount of its capital stock issued for cash and other assets (R. III, 7, 15, 17).¹³ After recouping all expenses, its overall net operating income or profit has exceeded \$86,000,000 (R. III, 17, Sched. 4).

2. *Actual experience under prescribed rates*

A sound test to measure a complaint that rates are confiscatory is the actual financial experience of the public utility thereunder. *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 163; cf. *Louisville v. Cumberland Tel. & Tel. Co.*, 225 U. S. 430, 433, 436; *Knoxville v. Knoxville Water Co.*, 212 U. S. 1, 16, 18; *Lincoln Gas Co. v. Lincoln*, 250 U. S. 256, 262, 268; *Brush Electric Co. v. Galveston*, 262 U. S. 443, 446. Even against the backdrop of its very profitable history, the actual experience of the Company under

¹² The precise figures are (R. III, 7, 15, 17):

Capital stock issued for cash.....	\$15,000,000
Capital stock issued for property.....	1,369,300
Total	16,369,300
Dividends paid in cash.....	97,273,640
Dividends paid in capital stock.....	11,000,000
Total	108,273,640
Earned surplus accumulated.....	8,159,170

¹³ On an average *invested* capital of \$23,198,278, Hope has earned an average of \$2,772,210 annually (R. III, 15), or about 12% per year.

the lower rates prescribed by the Commission, since July 15, 1942, when they became effective, answers any claim of confiscation.¹⁴

The Commission allowed Hope a 6½% rate of return on investment. During 1939, 1940 and 1941, the Company paid dividends of 10% on its common stock (R. III, 14); and in the year 1942, during about half of which the lower rates were in effect, it still found it possible to pay dividends of 7½%. During the three years 1940-1942, Hope's earned surplus increased by \$8,500,000, to a total of almost \$14,000,000, an increase sufficient to pay a 50% dividend on all outstanding capital stock (Appendix B, Table 4). The liquidity and affluence of the Company may be gathered from the fact that at the end of 1942, its financial position per books showed nearly as great an investment represented by cash and Government bonds as by net utility plant in service. (Appendix B, Table 4.)

In fixing the rates for the future, the Commission employed the Company's 1940 level of gas sales and revenues (R. I, 51, 70). But during the four years 1939-1942, Hope's interstate gas sales

¹⁴ The results of the Company's operations for 1941 and 1942 are not in the record but have been made available by the Company to the Commission in sworn statement form. They appear in Appendix B, pp. 136-140, *infra*. At the oral argument we shall move for leave to have this material included in the record.

and revenues showed a considerable increase (Appendix B, Tables 1 and 2):

Year	Interstate gas sales, MCF	Interstate gas revenues
1939	41,350,599	\$14,866,894
1940	53,604,243	19,296,755
1941	63,685,009	22,835,340
1942	69,960,811	25,229,783

The additional 16,000,000 MCF of gas sold in 1942 as compared with 1940 would, at the old rates, have correspondingly increased Hope's gas revenues more than \$6,000,000 (Appendix B, Tables 1 and 2). Had the Commission used the 1942 level, which was not accompanied by a corresponding increase in operating expenses, the Commission would have been justified in making an additional substantial reduction in Hope's rates. For the prescribed rates, based upon 1940 operations and limited to a $6\frac{1}{2}\%$ rate of return, would have resulted in a reduction of \$4,757,452 in Hope's 1942 revenues, had they been in effect for the entire year; whereas if the rates had been based upon 1942 operations and likewise limited to a $6\frac{1}{2}\%$ rate of return, the reduction in 1942 revenues would have been \$5,849,242. Therefore, even under the prescribed rate reduction, Hope is earning \$1,091,790 annually in excess of a $6\frac{1}{2}\%$ rate of return, if the 1942 level is taken as the criterion (Appendix B, Tables 1, 1-A and 5). This excess of \$1,000,000 is equiv-

alent to a $6\frac{1}{2}\%$ return on a \$16,800,000 investment, which is equivalent to adding this amount of investment to the rate base for the year 1942.

3. *The rate base sought by Hope does not square with its financial history*

How wide of the mark falls Hope's complaint of confiscation may be gathered by equating its average rate of earnings against the rate base to which it claims to be entitled. The Commission allowed a rate base of \$33,712,526 (R. I, 50). Hope sought a base of some \$66,000,000 (R. I, 20-23), founded upon estimates of "reproduction cost new" amounting to about \$97,000,000, and estimates of "trended original cost" amounting to about \$105,000,000, alleged to be evidence of present "fair value." These estimates were obviously too conjectural and illusory (R. IV, 180) to support a finding of confiscation as a result of their rejection in favor of the recorded and accurate cost figures. *Los Angeles Gas Co. v. Railroad Commission*, 289 U. S. 287, 319; *Railroad Commission v. Pacific Gas & Electric Co.*, 302 U. S. 388, 397. But apart from their unreliability, if Hope's estimates are accepted, Hope's average rate of return for the four-year period from 1937-1940 would amount to only 3.27% (R. I, 481). "So modest a rate suggests an inflation of the base on which the rate has been computed" for "men do not transact business without protest at confiscatory rates." *Dayton Power & Light Co. v.*

Public Utilities Commission, 292 U. S. 290, 311-312. Not only has Hope never seen fit to apply for leave to increase its rates pursuant to Section 5 (a) of the Act, but its gas plant has been well maintained and operated and during this period it has received an annual average return of about 9% on the average investment (R. III, 13-17; 21-24). Such a financial history completely disposes of any contention that during the years 1937-1940 Hope was not receiving an adequate return. Cf. *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151.

4. *Doubtful items of substantial amount were resolved by the Commission in Hope's favor*

The reduction in rates ordered by the Commission, amounting to about \$3,600,000 annually, was reached after the allowance of substantial items in the rate base and in operating costs which the Commission might well have excluded. The resolution of these doubts in Hope's favor by the Commission, resulting in an increase in the rate base of perhaps \$26,000,000 and an increase in allowed operating costs of some \$600,000, renders well-nigh impossible any clear or convincing showing that the prescribed rates are confiscatory. Cf. *Lindheimer v. Illinois Telephone Co.*, 292 U. S. 151, 175. These are some of the more important instances in which doubts were resolved in favor of Hope and liberal allowances made to it as a consequence:

1. Items totalling almost \$26,000,000 were included in the rate base although strong arguments were presented for their exclusion, to wit:

(a) The Commission included in the rate base \$1,295,953 representing plant costs in 1918-1923, which were first capitalized by Hope and then arbitrarily charged off to operating expenses (R. I, 35). Since the Company had already recouped that amount from the revenues paid by rate payers during the years for which those items were included in operating expenses, the Commission would have been justified on purely equitable considerations in excluding that total from the rate base.

(b) The Commission (one member dissenting) deducted from actual original cost only \$22,328,016 for accrued depletion and depreciation. This was about \$24,000,000 less than the amount which Hope had already accrued on its books for depletion and depreciation (R. I, 50, 80-89; R. III, 175-176). Hope could hardly have been heard to complain if the Commission had accepted the Company's own figures, as Commissioner Scott urged; yet the lesser sum was deducted, giving a correspondingly larger rate base.

(c) The Commission included in the rate base Hope's entire gas acreage costing \$566,105, notwithstanding that some of it is not being presently used in the Company's business and therefore might well be rejected as a base for a return to the Company (R. I, 47-48).

(d) As the court below noted, the Commission included in the rate base \$277,820 more for working capital than Hope's corrected claim totalled for that item (R. IV, 193-194).

2. Doubtful items totalling more than \$600,000 were added to annual operating expenses and thus reflected in the prescribed rates, to wit:

(a) The Commission allowed, on a cost basis, \$1,460,037 in annual operating expenses for annual depletion and depreciation. This allowance is greater by some \$120,000 than that which Hope's claimed annual rates for depreciation would have produced (R. I, 52-53; R. III, 207-209).

(b) At the Company's request, \$138,018 for administrative and general expenses was allowed in operating expenses for 1940, although such amount was formerly capitalized by election of the management (R. I, 49-50).

(c) The Commission added \$421,160 to the 1940 figures for operating expenses, which already exceeded 1939 operating expenses by \$2,300,000 (R. I, 62). This included an allowance for increased West Virginia property taxes, even though the Company had represented to the Commission that, as a result of the ordered rate reduction, it expects to save \$338,000 annually in West Virginia property taxes (Hope's Reply Brief before the Federal Power Commission, p. 52).

3. The Commission allowed Hope a return of $6\frac{1}{2}\%$ upon its rate base (R. I, 4). This is to be contrasted with the $5\frac{1}{2}\%$ return allowed by the

Commission to electric utilities (*Chicago District Electric Gen. Co.*, 2 F. P. C. Rep. 412 (1941)), and the even lower rate of 5% allowed by the Illinois State Commission—a rate which in itself raises no substantial Federal question. *Peoples Gas Light & Coke Co. v. Slattery*, 373 Ill. 31, 25 N. E. (2d) 482, appeal dismissed, 309 U. S. 634. See also *Knorrville v. Knorrville Water Co.*, 212 U. S. 1, 17.

In the acoustics of such liberality, the cries of confiscation ring hollow indeed.

The court below rejected the Commission's order prescribing rates because of what it regarded as a failure to observe certain required formulae in computing the rate base and the annual operating expenses. Even if the court was qualified to consider separately each item going into rate base and operating expenses, and the methods and theories of computation utilized by the Commission, we believe the objections to the Commission's order were unfounded.

These objections, which will be treated under Points II through VI of this brief, are directed to the use of a prudent investment rate base (Point II), the exclusion therefrom of certain well-drilling expenses (Point III), the determination of the accrued depreciation and depletion (Point IV), the annual allowance for such items (Point V), and the exclusion from 1940 operating expenses of expenditures for an experimental well (Point VI).

THE COMMISSION MAY PROPERLY USE A "PRUDENT
INVESTMENT" RATE BASE

Chief among the court's objections to the Commission's order was the use of Hope's "prudent investment" in its interstate plant to compute the rate base. Since Hope had kept complete documentary evidence of its expenditures throughout its entire existence, the Commission found that this was the best evidence of the actual legitimate cost of Hope's plant, so that no estimates were needed (R. I, 23, 174). Upon the basis of Hope's own records, and after a check of the inventory of Hope's property in service, the Commission determined the cost of Hope's facilities devoted to interstate commerce, as of December 31, 1940, to be \$51,957,416 (R. I, 3, 50). After deducting therefrom accrued depletion and depreciation, and adding thereto certain items for working capital, future capital additions and useful acreage, the Commission obtained a total rate base of \$33,712,526 (R. I, 45, 50). Hope, on the other hand, claimed a rate base of some \$66,000,000, and to support it offered evidence of "present fair value," consisting of estimates of "reproduction-cost-new" of Hope's plant, amounting to about \$97,000,000, and estimates of "trended-original-cost" of the plant amounting to about \$105,000,000. These estimates the Commission admitted in evidence and analyzed. However, it discarded them

as not being predicated upon facts and as too hypothetical, conjectural, and illusory to be accorded probative value in the proceedings (R. I, 20-22). The Commission also rejected Hope's argument that post-investment changes in price levels had to be reflected in the rate base (R. I, 20-23, 36, 41, 52). It accordingly adopted as the rate base the actual legitimate cost (depreciated) of the Company's facilities used in interstate commerce (R. I, 20-21, 36-50).¹⁵

The court below agreed with the Commission that Hope's estimates of "reproduction-cost-new" and "trended-original-cost" were too conjectural and illusory to be given any weight in determining the rate base (R. IV, 180). It nevertheless ruled that the prescribed rates were both confiscatory in the constitutional sense and unjust and unreasonable in the statutory sense,¹⁶ for failure to reflect, as required by the rule of *Smyth v. Ames*, 169 U. S. 466, the increase in the present fair value of Hope's property since it had been installed, caused by the decided rise in the price level which the court discerned in Hope's estimates and of which it took judicial notice (R. IV, 180).

¹⁵ By stipulation, Hope's distribution property and property used to transport coke-oven gas were excluded from the proceeding (R. I, 18).

¹⁶ The lower court recognized, in accordance with *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 586, that the statutory standard of "just and reasonable" (Section 5 (a)) coincided with the constitutional test of confiscation (R. IV, 175).

In so holding, the court below disregarded the clear intent of Congress that the Commission should, subject to constitutional limitations, use prudent investment in determining the rate base. It likewise disregarded the recent decision of this Court in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, indicating that a rate base so determined is not *ipso facto* unconstitutional. Moreover, the court below imposed upon the Commission, without warrant in law, an obligation to find a "present fair value" of Hope's interstate properties on the basis of price trends.

A. THE NATURAL GAS ACT CONTEMPLATES USE OF PRUDENT INVESTMENT IN DETERMINING RATE BASE, SUBJECT TO CONSTITUTIONAL LIMITATIONS

The Natural Gas Act requires that interstate gas rates shall be "just and reasonable" (Sec. 4 (a)), and empowers the Commission to prescribe "just and reasonable" rates for the future and to order a decrease where existing rates "are not the lowest reasonable rates." (Sec. 5 (a)). The only formulae laid down by Congress to guide the Commission in exercising its rate-making powers, are those contained in Section 6.

SEC. 6. (a) The Commission may investigate and ascertain the *actual legitimate cost* of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination

of such cost or depreciation and *the fair value of such property.*

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the *original cost* thereof, and shall keep the Commission informed regarding the *cost* of all additions, betterments, extensions, and new construction. [Italics supplied.]

The emphasis upon actual and original cost, and the absence of any mention of "present fair value," lead to an inference that Congress intended the Commission to put primary if not exclusive reliance upon prudent investment. This inference becomes a definite indication of Congressional intention when considered with the House and Senate Committee reports on the bill which became the Natural Gas Act. These reports, in making a sectional analysis of the bill, refer only to original cost and not to "fair value" (H. Rep. No. 709, 75th Cong., 1st Sess., p. 5; S. Rep. No. 1162, 75th Cong., 1st Sess., p. 4).

That Congress desired the Commission to base rate making on prudent investment to the extent the Constitution permitted, is further to be gathered from a statute in *pari materia* with the Act here involved, and entrusted to the administration of the same agency: the Federal Power Act, enacted as Title II of the Public Utility Act of 1935. As originally introduced in the Sen-

ate, Section 208 of S. 2796 (which became the Federal Power Act), whose language is identical with that of Section 6 of the Natural Gas Act, specifically placed rate regulation on the prudent investment basis. S. 2796, 74th Cong., 1st Sess. The Senate Committee on Interstate Commerce in favorably reporting the bill, approved such a rate-making basis (S. Rep. No. 621, 74th Cong., 1st Sess., at p. 52):

Rate regulation must eventually be based on prudent investment. Recent decisions of the Supreme Court * * * afford grounds for the hope that this rule which the Committee considers essential to effective rate regulation will be sustained if the Congress should now definitely adopt it as a legislative policy.

An amendment offered by Senator Bailey, requiring the use of "fair value" as the rate base was not accepted (79 Cong. Rec. 8858), and on June 11, 1935, the Senate passed S. 2796, providing in Section 208 (c) that in determining just and reasonable rates, the Commission shall fix a rate base "not in excess of the actual legitimate cost of the property." 79 Cong. Rec. 9065; see also S. Rep. No. 621, 74th Cong., 1st Sess., p. 20.

However, on June 3, 1935, this Court had reaffirmed the doctrine of *Smyth v. Ames* in *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662. The House Committee apparently read the *West* decision as casting doubt on the constitutionality of

adopting prudent investment as the exclusive rate base, for in considering S. 2796, it deleted Section 208 (c) and inserted Section 208 (a), authorizing the Commission to ascertain actual legitimate cost, with the further authorization to ascertain "fair value," "when necessary for rate-making purposes." H. Rep. No. 1318, 74th Cong., 1st Sess., p. 30.

This legislative material leads to the conclusion that while Congress did not bind the Commission to the use of any single formula in determining the rate base (*Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575), it did intend the Commission to use prudent investment, and to consider "fair value" only if constitutionally necessary. Independent legal opinion, exemplified in the 1940 report of the Special Committee of the Public Utility Law Section of the American Bar Association, concurs in this view.¹⁵

¹⁵ The Committee, analyzing Section 208 of the Power Act and the companion Section 6 of the Gas Act, stated (1940 Report, pp. 14-15):

"It will be noted that the primary duty of the Commission under these two provisions is to ascertain the cost of the property and the depreciation therein and that 'other facts which bear on the determination of such cost or depreciation, and fair value of such property' are to be determined only 'when found necessary for rate-making purposes.' There is here the possible inference that the Congress, when it drafted this provision, was hopeful that the courts would decide that nothing other than the 'actual legitimate cost' of the property would be 'found necessary for rate-making purposes.' However that may be, it is patent that an accounting or cost rate base was dominant in the Congressional mind, and that these

B. THERE IS NO CONSTITUTIONAL PROHIBITION AGAINST THE DETERMINATION OF A RATE BASE SOLELY ON PRUDENT INVESTMENT

This Court, in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, had before it the propriety of a base selected by the Commission under the Natural Gas Act for the determination of an annual amortization allowance chargeable to operating expenses. This Court ruled that the owner of a "wasting-asset business of limited life" such as the company there involved, has no constitutional right to a return of more than its original investment, even though the reproduction cost of the company's property during the period in question is greater than the original cost. The reason assigned for the validity of disregarding the appreciation in the value of the plant was that "this theoretical accretion to value represents no profit to the owner, since the property dedicated to the business, save for its salvage value, is destined for the scrap-heap when the business ends" (315 U. S. at 593). While this issue did not involve the determination of a rate base on which the owner is entitled to a return, the applicable principles would seem to be the same as where a base for annual amortization allowance is in question. For if the owner of a "wasting-asset business of limited life"

very recent statutes in that respect are the very antithesis of some of the older state statutes which prescribe the reproduction cost less depreciation formula."

does not have a constitutional right to recover more than his original investment, he can scarcely be entitled to an annual fair return upon more than such investment. The "theoretical accretion" to the original investment, which under the decision of this Court need not be returned to the owner in the form of annual amortization allowances, by parity of reasoning need not be recognized as a basis for an annual return in the form of earnings. Any line of distinction between these propositions would produce the anomaly of a requirement that an owner receive an annual return *upon* the accretion without being entitled to a return *of* the accretion itself—the fabrication of a constitutional right to receive piecemeal during the life of a business that which the owner is not entitled to receive in one lump sum at the expiration of its life. The determination of an amortization base is no more integral in the rate-making process than the determination of a rate base (cf. *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151, 164). If the Commission is authorized to use actual legitimate cost for the former purpose as this Court held in the *Pipeline* case, it must be equally authorized to use it for the latter purpose.

Even if the decision of this Court in the *Pipeline* case be deemed limited to "wasting asset businesses of limited life," its applicability to the instant case would be clear. As will be shown more fully hereinafter (pp. 102-103), companies such as Hope, engaged in the extraction and sale of

natural gas, are in a real sense "wasting asset businesses of limited life"; for according to accepted scientific principles, the wells and pools from which the gas is being withdrawn will inevitably be exhausted within a predictable future.

While this Court in the *Pipeline* case did not explicitly denounce the so-called rule of *Smyth v. Ames*, which requires that reproduction cost be considered in determining a rate base, we suggest that the decision in effect leaves the Commission free to reject conjectural estimates of reproduction cost and to adopt prudent investment as the rate base.¹⁶

C. THE COURT BELOW ERRED IN REQUIRING THAT PRICE TRENDS BE UTILIZED IN DETERMINING THE RATE BASE

In support of its claim to a \$66,000,000 rate base, Hope sought to prove the "present fair value" of its interstate facilities by offering esti-

¹⁶ This was gathered from the opinion of the majority not only by the three Justices concurring in a separate opinion (315 U. S. 575, 606), but also by the Public Utility Law Section of the American Bar Association (1942 Report, pp. 121-122) and the Committee on Progress in the Regulation of Public Utilities of the National Association of Railroad and Utilities Commissioners (Proceedings of 54th Annual Convention (1942) pp. 223-227). See also *Implications of the Case of F. P. C. v. Natural Gas Pipeline Co.*, Public Utilities Fortnightly, October 22, 1942, pp. 604-618.

The dissenting judge below also construed the *Pipeline* case to hold that there was no constitutional objection to the Commission's exclusive use of the prudent investment method; and he concluded that the Commission's order was within the scope of its statutory authority, reasonable, and supported by substantial evidence (R. IV, 203-205).

mates of "reproduction cost new" and "trended original cost" (R. I, 143-208). The Commission received Hope's estimates of "present fair value." However, when analysis revealed such estimates to be erroneous and conjectural, the Commission rejected them in favor of the actual legitimate cost, as reliably shown by Hope's complete books and records (R. I, 20-23). The court below agreed with the Commission as to the unreliability of such estimates, but held that decided price-rises since the original investment, which the court found in the record and judicially noticed, should have been taken into account in the rate base (R. IV, 172, 183-184). In this we submit the court erred, both in its assumption of fact and in its conclusion that price-trends were any more reliable than reproduction-cost estimates.

1. *There is no evidence that present value is greater than original cost.*

In setting aside the Commission's rate order because it disregarded post-investment price rises, the court apparently assumed that the original cost of Hope's properties was substantially lower than their present value. There is little to support such an assumption. Although Hope has been in existence over forty years, it has been adding to its property gradually during all that time. The opinion below appears to assume that Hope acquired most of its property during periods of low prices. The facts belie this assumption. Ac-

according to Hope's Exhibit 20 (R. I, 207, col. 2), only \$25,000,000 of a claimed original cost of \$70,000,000 was installed prior to 1917, and the rest (\$45,000,000) was installed thereafter, when prices were rising. Included in these figures are the intangible costs of well-drilling originally charged to operating expenses, most of which were incurred prior to 1917; the exclusion of these costs would reduce substantially the \$25,000,000 figure (Exhibit 20, p. 66). Moreover, the property installed during the low-price period has been largely depreciated. Therefore, although the price level has unquestionably risen since Hope first began operations, its substantial capital expenditures during the period of higher prices, coupled with the depreciation of its low-cost equipment, may well give a "present-value" figure not far removed from original cost.

2. Results obtained by use of price trend factors are illusory and unreliable

Even on the assumption that the present value of Hope's properties exceeds its original cost, the "price-trends" which the court below held to be a mandatory factor in the rate base are no more reliable than the estimates of fair value which the Commission rejected with the court's approval. The Commission is not aware of any method of "price trending"—whether general or specific—which does not share the inherent qualities of conjecture and illusion found in the cus-

tomary methods of determining "reproduction cost" and "trended original cost," as the court below conceded and as shown in the Supplement to this Brief (pp. 4-26, 42-48).

(a) *Specific* price trend factors may be applied in two ways. The first method is to obtain the quantity of labor or materials of a given class which went into a plant at the time of construction, and then to translate that quantity into present prices by comparing present prices with the original prices. For instance, if hourly cost of labor had by 1940 increased 300% over the cost in 1900, the estimated total cost of labor expended in 1900 in plant which is in service in 1940, would be multiplied by the translator factor of 300.

Where the translator is applied directly to the various elements which go to make up a plant, such as labor, materials and services, unreliable results are inevitable. For example, to use the illustration involving labor, Hope in this case multiplied the estimated labor costs incurred many years ago by a translator factor which recognized present prices of labor, without giving any recognition whatever to the increase in efficiency which has taken place and the consequent greater productivity of the same amount of labor, particularly through the use of modern tools and machines and through the reduction in the work day (R. III, 101-108). Thus, if labor costs of \$100,000 went into the plant in 1900, and if the hourly rate of labor is now three times as great,

the original labor costs multiplied by 300%, or \$300,000, would be the estimated value of the labor item in 1940, under the trended original cost. This assumes that the old methods of laying pipeline would prevail in 1940 and that the trench for "Big Inch" would today be dug by pick and shovel—assumptions wholly at variance with the facts. Similarly, in the case of gas mains, the old quantity at the old cost is multiplied merely by the translator factor which recognizes present prices, without giving any effect whatsoever to the improvements made in long distance transmission (R. III, 110-119). It is clear, therefore, that no better results would be obtained by the use of index numbers or price trends than have been obtained by reproduction cost studies. As a matter of fact, in many instances the results would be identical.

The other method of applying specific price trend factors involves a comparison of unit costs at the time of construction with "current reproduction" unit costs. To illustrate, if in 1900 a section of pipe cost \$5,000 installed, and the estimated cost of reproduction was \$7,500 in 1940, a translator of 150 would be applied to the investment figure. It is obvious that use of the unit cost method results automatically in the reproduction cost figure; hence, the translation of original cost into present values by this method suffers from all the infirmities of reproduction cost estimates.

(b) *General price trends* are used to determine the changes in the purchasing power of a dollar, rather than to translate the actual costs of specific facilities into present costs.¹⁷ The use of general price trends to determine a rate base proceeds on the assumption that a dollar invested in Hope in 1900 should retain the same purchasing power in 1940; that is, its value should be maintained at such a level as to buy as much shelter, food, clothing, entertainment, etc., in 1940 as it could purchase in 1900. This method uses general index numbers rather than specific index numbers as the translator, but it possesses all the infirmities notoriously inherent in the reproduction cost method for which it has on occasion been substituted. Cf. *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 669-670. Moreover, while it is probably true that the index-number method can give just as accurate results as those obtained by use of reproduction cost and in less time, it is subject to additional objections. There are no satisfactory indices with which to value the dollar. No one knows the exact manner in which an investor in 1900 would have desired to spend a dollar, or the manner in which the same or another investor might desire to spend a dollar in 1940. The indices for this purpose are rather crude, and their use has a more logical relation to monetary control than to the valuing of specific

¹⁷ See *West v. Chesapeake & Potomac Telephone Co.*, 295 U. S. 662.

public utilities. Moreover, the problem is not so much that of maintaining the purchasing value of the dollar as it is of maintaining the investment at its original amount. Large classes of investors, such as bondholders and preferred stockholders, make their investments under contracts by which they are to receive the principal amount of their investment (or par) and no more, irrespective of fluctuations in the price level. Common stockholders, on the other hand, may be adequately protected by adjusting the rate of return. Finally, the value of the dollar and the value of specific utilities may point in opposite directions, as occurred in the case of street railways in the 1920's. Cf. Brandeis, J., dissenting in *St. Louis & O'Fallon R. Co. v. United States*, 279 U. S. 461, 494-496.

These weaknesses in the use of price trends are magnified by the compulsory force to which the court below held them entitled. But apart from the unreliability of price trends, there is no warrant in law for the imposition of an obligation upon the Commission to utilize them. The Constitution "does not bind rate-making bodies to the service of any single formula or combination of formulas." *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 586. Yet the view of the majority below would restrict that freedom of choice by imposing the condition that the formula chosen in any case must yield a result

generally equivalent to that which would be obtained from the use of price trends. The *Pipeline* decision forecloses any contention that a rate order founded upon a prudent investment rate base is arbitrary simply because a larger rate base would result from the adoption of a formula reflecting prevailing price levels. Thus, the decision there sustained the use of an amortization base reflecting actual legitimate cost regardless of the fact that another basis of determination, taking into account post-investment fluctuations in price levels, would have yielded a larger sum. The question is not whether the use of price trends is permissible (cf. Stone, J., dissenting in *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 690) but whether it is mandatory; and this Court in the *Pipeline* case has in our view answered this in the negative.

For these reasons, we submit that the use of price trends was improperly held below to be a necessary factor in rate making.

D. THE RULE OF *SMYTH V. AMES* SHOULD BE RENOUNCED

We believe that the circumstances discussed above, and the similiarity between Hope's business and that involved in the *Pipeline* case, would warrant reversal of the decision below without further reconsideration of the doctrine of *Smyth v. Ames*. But since it is not certain that the vitality of that doctrine is at an end (see, e. g.,

Hale, *Does the Ghost of Smyth v. Ames Still Walk?*, 55 Harv. L. Rev. 1116), we respectfully urge this Court, in the interest of clarifying the Commission's functions as well as those of all other rate-making bodies, to place the troublesome phantom in its grave, and thus terminate the unsound and uneconomic dogma which it has evoked.

In offering argument against the "fair value" concept and in favor of the "prudent investment" concept of rate making, we ask the Court's indulgence, realizing that it is well informed on the subject and has on numerous occasions given judicial attention to the matter. Various members of the Court have, upon several occasions, severely criticized the "mischievous formula for fixing utility rates in *Smyth v. Ames*". *Driscoll v. Edison Light & Power Co.*, 307 U. S. 104, 122 (Frankfurter, J., concurring); *McCart v. Indianapolis Water Co.*, 302 U. S. 419, 423 (Black, J., dissenting); *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 292 (Brandeis, Holmes, J. J., dissenting); *St. Louis & O'Fallon R. Co. v. United States*, 279 U. S. 461, 551-552 (Brandeis, Holmes, Stone, J. J., dissenting); *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 680 (Stone, Brandeis, Cardozo, J. J., dissenting). However, we believe that such argument is appropriate because

the conflict between the two concepts presents the major issue in this case.¹⁸

We have printed in a Supplement to this brief various pertinent materials, including excerpts from the brief filed by the United States as *amicus curiae* in *Driscoll v. Edison Light & Power Co.*, No. 509, October Term, 1938, and from the supplement to the Commission's brief in *Federal Power Commission v. Natural Gas Pipeline Co.*, Nos. 265 and 268, October Term, 1941. These materials show "the havoc raised by insistence on reproduction cost" as "a matter of historical record," how the rule of *Smyth v. Ames* "has seriously impaired the power of rate-regulation," how the "fair value" rule "has proved to be unworkable by reason of the time required to make the valuations, the heavy expense involved, and the unreliability of the results obtained"; and

¹⁸ Hope contended below that the general question whether the Commission may use the prudent investment method of rate making is not presented, since neither the Commission nor its staff had so designated the principal item used in determining the rate base. This is little more than a quibble. Since the wisdom of Hope's plant costs and investments has not been questioned, the actual legitimate cost or gross plant investment as determined by the Commission is synonymous with "prudent investment." *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 289 (Brandeis, J., dissenting); *Los Angeles Gas Co. v. Railroad Commission*, 289 U. S. 287, 306. The separate opinion of Commissioner Scott clearly demonstrates that the Commission considered actual legitimate cost to be synonymous with prudent investment (R. I. 81).

how "even the investor, on whose behalf the constitutional safeguards have been developed, has received no protection against the rebounds from the inflated stock-market prices that are stimulated by the 'fair value' doctrine." (*Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 605-606.) These materials also show that the prudent investment approach produces a sound and workable rate base; that it curtails the length and expense of rate litigation and regulation; and that it protects the interests of both the consumers and the investors.

Here we shall show, in addition, that the "fair value" rule is based on principles of eminent domain which are irrelevant in rate making; that in rate regulation, as in price fixing, the reasonableness of the regulation should be the guiding principle; and that the allowance of a fair return on the capital prudently invested in the enterprise is reasonable.

While the material contained in pages 53-70 *infra*, is in large measure derived from the discussion in the Government's brief in the *Pipeline* case, we include it here, in somewhat condensed form, since the issue seems to us to be more centrally raised in this case, and its inclusion, in lieu of mere reference thereto, will serve the convenience of the Court and of the several parties in Nos. 34 and 35.

1. *The fair value rule is based on eminent domain concepts*

The rule that a rate is confiscatory unless it enables the utility to earn a fair return on the present fair value of its property is based on the doctrine in the law of eminent domain that "just compensation" must be paid for property "taken" for public use. *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 671; cf. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 602, 603.

This is confirmed by the historical development of the fair value rule. While at first protection against abuses in rate regulation was held to lie at the polls, not in the courts (*Munn v. Illinois*, 94 U. S. 113, 134), this view was later abandoned and the question of the reasonableness of rates was recognized to be justiciable, unreasonably low rates being held to constitute a deprivation of property without due process of law or a taking of property without just compensation. *Railroad Commission Cases*, 116 U. S. 307, 323, 331; *Georgia Railroad & Banking Co. v. Smith*, 128 U. S. 174, 179; *Chicago & N. W. Ry. v. Minnesota*, 134 U. S. 418, 458; *Budd v. New York*, 143 U. S. 517, 547. The "fair value" rule emerged shortly thereafter in *Reagan v. Farmers' Loan & Trust Co.*, 154 U. S. 362, which invalidated a rate order under which the company could not pay even one-half of its bond interest. The Court there observed *obiter* that the Constitution prohibits a taking of

"the use [of property] for the public benefit at less than its market value," just as it forbids acquisition of title to the property by eminent domain at less than "the value of the property as it stood in the markets of the world" (154 U. S. at 410).¹⁹

The analogy of a "taking" was not expressly referred to again until the lower court in *Smyth v. Ames* held that the earning of "a fair interest on the actual value of the property" of the railroad company is a measure of the reasonableness of rate reductions, just as in condemnation of title to the railroad "the present value of the property, and not the cost" is the proper measure of compensation. *Ames v. Union Pacific Ry.*, 64 Fed. 165, 177 (C. C. Neb.).

This text extracted from the law of eminent domain became the basis of the "fair value" rule of *Smyth v. Ames*, 169 U. S. 466, for determining the constitutionality of rates. See Henderson, *Railway Valuation and the Courts*, 33 Harv. L. Rev. 902, 906-912; Hale, *Conflicting Judicial Criteria of Utility Rates*, 38 Col. L. Rev. 959, 960-964. The rule is invoked to prevent rate regulation on any basis other than "present fair value"

¹⁹ In *Cornington & Lexington Turnpike Road Co. v. Sandford*, 164 U. S. 578, 596, the Court observed that rates fixed so low as to destroy the value of property for all purposes would be invalid as a deprivation of property without due process of law.

(cf. *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662), notwithstanding that when *Smyth v. Ames* was decided, original cost probably exceeded the "present fair value" of the utility's property, so that the original effect of the rule was to permit rates to be based on a value less than original cost.

2. *The eminent domain concept of present fair value is inapplicable to rate regulation*

In practice the "present fair value" test makes it impossible to measure the reasonableness of rates by any coherent standard, and renders rate regulation logically impossible.

The practical impossibility of developing a workable rule under the "present fair value" concept arises fundamentally from the fact that eminent domain principles have no proper application in the field of rate regulation. See Hale, *Conflicting Judicial Criteria of Utility Rates*, 38 Col. L. Rev. 959, 963.²⁰ Even before *Smyth v. Ames* was decided, it had already been established in a utility condemnation case that "the value of property, generally speaking, is determined by its productiveness—the profits which its use brings to the owner" (*Monongahela Navigation*

²⁰ It was precisely this principle of "just compensation" that led Mr. Justice Field in 1877 to dissent in *Munn v. Illinois*, 94 U. S. 113, and to deny any power in the States to regulate rates. 94 U. S. at 143.

Co. v. United States, 148 U. S. 312, 328-329; see *C. C. C. & St. L. Ry. v. Backus*, 154 U. S. 439), and that compensation must be paid not only for the physical property but also for the franchise. Earning power under the old rates thus became the test of value in condemnation cases. Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 519-520; Hale, *Conflicting Judicial Criteria of Utility Rates*, 38 Col. L. Rev. 959, 964.²¹ In a rate case, however, the earning power necessarily depends on the rates to be allowed, which is the very question at issue.

Any physical property has only a scrap value unless it is capable of earning a return sufficient to justify a larger evaluation; consequently, the rate level, whose determination must await computation of "fair value" under *Smyth v. Ames*, is itself the prime factor in that value. Cf. *Ecker v. Western Pacific R. Corp.*, 318 U. S. 448, 483; *Group of Investors v. Milwaukee R. Co.*, 318 U. S. 523, 540; *Consolidated Rock Co. v. DuBois*, 312 U. S. 510, 525. The value of a going concern in fact depends on earnings under whatever rates may be anticipated. The present fair value rule creates but offers no solution to the dilemma

²¹ Of course, where the property of a nonutility without franchise is condemned, it is only the physical property and not the earning power or prospective profits that are taken and paid for. *Mitchell v. United States*, 267 U. S. 341; *Joslin Co. v. Providence*, 262 U. S. 668; *Bothwell v. United States*, 254 U. S. 231.

that value depends upon the rates fixed and the rates upon value. See Brandeis, J., concurring in *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 292; *Federal Power Commission v. Natural Gas Pipeline Co.*, *supra*, at 603 (Black, Douglas, Murphy, J. J., concurring); *Los Angeles Gas Co. v. Railroad Commission*, 289 U. S. 287, 305; *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 689 (Stone, J., dissenting); Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517-520; 2 Bonbright, *Valuation of Property*, pp. 1094 et seq.; Henderson, *Railway Valuation and the Courts*, 33 Harv. L. Rev. 1031.

The utter illogicality of invoking eminent domain principles of "just compensation" in rate regulation is best shown by the fact that strict application of those principles would render all rate regulation invalid or impossible. When property is taken under the power of eminent domain, the owner is "entitled to the full money equivalent of the property taken, and thereby to be put in as good position pecuniarily as it would have occupied if its property had not been taken." *United States v. New River Collieries Co.*, 262 U. S. 341, 343. Since the value of a public utility depends on earning power, under condemnation principles its present value would have to be measured by its earnings at the existing rates, and would be calculated by capitalizing those earnings at the prevailing rate of return upon investments involv-

ing similar risks. On the rate base thus determined, a fair return would have to be allowed which would, of course, be the rate of return on investments involving similar risks. The result would be no change in rates at all. This absurdity results from the truism that every rate reduction which reduces the net earnings of a utility *ipso facto* reduces the value of that utility; if the value prior to the rate reduction must be preserved for constitutional reasons, it necessarily follows that every rate order which reduces that value is invalid.²² See Barnes, *The Economics of Public Utility Regulation* (1942), pp. 401-402.

While not in terms abandoning the "taking" theory with its corollary requirements of "just compensation" (see *West v. Chesapeake & Potomac Tel. Co.*, 295 U. S. 662, 671), this Court has resolved the dilemma, albeit at the expense of logic, by holding that some rate regulation is

²² The dilemma is not evaded by the contention that the actual market value will be less than the capitalized earnings by reason of the fact that the market will take into account the prospect of future rate regulation. A business has greater value if its owner can anticipate earnings in excess of just and reasonable profits, and the prospect of future regulation does not entirely diminish that anticipation. Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 530. If, therefore, under eminent domain principles, market value, which is earning power in the case of a public utility, sets the measure of "just compensation" and if rates must be fixed to pay the utility "just compensation" in the eminent domain sense, rates can never be reduced below the market expectations prior to the rate proceedings, and adequate rate regulation is still impossible.

permissible. In part the Court has permitted the exclusion of value supposedly due to "monopoly" position (*Clark's Ferry Co. v. Public Service Commission*, 291 U. S. 227, 238; see Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 421-423; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 267), even though an exclusive franchise is an element of value in a condemnation case. *Monongahela Navigation Co. v. United States*, 148 U. S. 312, 328-329. In effect "value" became "a word of many meanings" (cf. *Group of Investors v. Milwaukee R. Co.*, 318 U. S. 523, 540), so that such factors as good will and earning power, while material to "exchange value" in condemnation cases, were excluded in determining the "special value" for rate purposes. See Brandeis, J., concurring in *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 310-311.

The very existence of the power to regulate rates, therefore, shows that the concepts of "just compensation" and "fair value", drawn from the law of eminent domain, have no place in rate cases. Bonbright, *op cit. supra*, pp. 1092-1096; Bauer and Gold, *Public Utility Valuation*, p. 147; Beutel, *Valuation as a Requirement of Due Process*, 43 Harv. L. Rev. 1249, 1267; Hale, *The "Fair Value" Merry-Go-Round*, 33 Ill. L. Rev. 517, 519, 530; Hale, *Conflicting Judicial Criteria of Utility Rates*, 38 Col. L. Rev. 959.

3. *Rate regulation should be deemed violative of due process only if arbitrary or unreasonable*

These dilemmas and inconsistencies are avoided if rate regulation is regarded not as a taking of property for public use, but simply as an exercise of regulatory power. There is adequate room for such a distinction. Eminent domain is the power to command a sale; it involves an appropriation of title or of the use of property which is essential to the Government's need and which promotes the public welfare. Lewis, *Eminent Domain* (3d ed. 1909) § 6. The taking is justified not because the property is a public nuisance or other obstacle to valid legislative ends, but because it is needed for some valid public purpose or project. Nichols, *Eminent Domain* (2d ed. 1917), p. 278; Orgel, *Valuation under Eminent Domain* (1936), p. 2; see Gardner, *The Massachusetts Billboard Decision*, 49 Harv. L. Rev. 869, 889-892.

The regulation of rates, on the other hand, promotes the public welfare, not by a "taking," but by regulating and restricting the owner's use and enjoyment of his own property. Lewis, *Eminent Domain* (3d ed. 1909), §§ 246, 249. Congress may of course subject the use of privately owned property to reasonable limitations in order to serve valid legislative ends, even though the regulation diminishes the value of the property. Under "the police power in its proper sense, * * * property rights may be cut down, and to that extent

taken, without pay." *Block v. Hirsh*, 256 U. S. 134, 155.

Examples of valid legislative regulations which diminish the value of property without compensation are numerous. A state may prohibit the manufacture of an article or the conducting of a business within certain territorial limits;²³ it may prohibit the emission of smoke from buildings even though this requires the discontinuance of the use of private property and the incurring of considerable expense (*Northwestern Laundry v. Des Moines*, 239 U. S. 486); it may limit the use of property and even destroy it outright, in order to save or benefit another class of property "which, in the judgment of the legislature, is of greater value to the public";²⁴ and it may control prices in appropriate circumstances. *Nebbia v. New York*, 291 U. S. 502. Such reasonable restrictions on the use of property in the interest of the public are not "takings" for which just compensation must be paid. *Monongakela Bridge Co. v. United States*, 216 U. S. 177, 193; *Union Bridge Co. v. United States*, 204 U. S. 364, 388-403; *West Chicago Street Railroad Co. v. Chicago*, 201 U. S. 506,

²³ *Powell v. Pennsylvania*, 127 U. S. 678 (oleomargarine); *Mugler v. Kansas*, 123 U. S. 623, 661 (intoxicating liquors); *Reinman v. Little Rock*, 237 U. S. 171 (livery stable); *Hada-check v. Los Angeles*, 239 U. S. 394 (bricks).

²⁴ *Miller v. Schoene*, 276 U. S. 272, 279-280; *Lawton v. Steele*, 152 U. S. 133; cf. *Standard Oil Co. v. Marysville*, 279 U. S. 582; *Euclid v. Ambler Co.*, 272 U. S. 365; *Pennsylvania Coal Co. v. Mahon*, 260 U. S. 393.

524; see Gardner, *The Massachusetts Billboard Decision*, 49 Harv. L. Rev. 869, 889-892.

The constitutional criteria applied to price-fixing regulations are of peculiar applicability to rate regulation. "Rate-making is one species of price-fixing. Price-fixing, like other forms of social legislation, may well diminish the value of the property which is regulated. But that is no obstacle to its validity." *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 603 (Black, Douglas, Murphy, J. J., concurring).

The power of the Government to fix prices or rates was formerly explained by saying that the regulated company had "dedicated" its property to the public use, but this has been characterized

²⁵ The "taking" concept has not even a superficial relevance to utility regulation except where the state requires a utility to extend its service (*New York & Queens Gas Co. v. McCall*, 245 U. S. 345; *New York ex rel. Woodhaven Gas, Light Co. v. Public Service Commission*, 269 U. S. 244) or forbids abandonment if the utility continues to do business anywhere within the state. *United Gas Co. v. Railroad Commission*, 278 U. S. 300, 308-309. No question of forbidding abandonment or compelling an extension is involved here. Any duty on the part of Hope to continue or extend its service is in effect based upon the community's dependence, for which the utility itself is responsible. Cf. Cardozo, J., dissenting in *Interstate Commerce Commission v. Oregon-Washington R. Co.*, 288 U. S. 14, 17. The instances are numerous and familiar in which a duty has been founded on dependence or reliance and in which the concepts of eminent domain are manifestly irrelevant. See, e. g., *Moch Co. v. Kennselaer Water Co.*, 247 N. Y. 160, 167; *Slater v. Illinois Central R. Co.*, 209 Fed. 480 (C. C. M. D. Tenn.); *Siegel v. Spear & Co.*, 234 N. Y. 479; *Creeley v. Creeley*, 258 Mass. 460, 463.

as "merely another way of saying that if one embarks in a business which public interest demands shall be regulated, he must know regulation will ensue." *Nebbia v. New York*, 291 U. S. 502, 534. In reality there is no true "dedication," for the property remains private property. *Minnesota Rate Cases*, 230 U. S. 352, 431-432; *Interstate Commerce Commission v. Oregon-Washington R. Co.*, 288 U. S. 14, 40-41.

Utility regulation, and rate fixing in particular, is thus not a "taking" of property for public use but an exercise of the police power in the form of a restriction upon the use or enjoyment of private property. The validity of such regulation does not depend upon impairment of the value of property; impairment of value is frequently the consequence of regulation. The true test of constitutionality under the due process clause in a rate case, as in all regulatory cases, is simply whether the regulation is reasonable. This is the standard in the analogous field of price fixing. This Court, after observing that there was nothing "peculiarly sacrosanct about the price one may charge," has held that "price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty." *Nebbia v. New York*, 291 U. S. 502, at 539.

4. *It is not unreasonable to limit the earnings of a utility to a fair return upon the capital prudently invested*

Measured by the principles governing the validity of regulatory acts of government, and particularly by those relating to price-fixing, the prudent-investment rate base chosen by the Commission easily passes muster.

As this Court held in considering the Natural Gas Act, the Constitution does not bind the Commission "to the service of any single formula or combination of formulas," but leaves it free, within the ambit of its statutory authority, "to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 586.

This decision leaves the regulatory body at liberty to select formulae suggested by sound business practice and producing no arbitrary result. We submit that an acceptable and reasonable formula is the prudent investment standard adopted by the Commission. This point requires little elaboration here. Mr. Justice Brandeis has demonstrated the reasonableness of the investment basis by reference to a wealth of relevant data.

See *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 289. Additional data are supplied in the Supplement to this brief (at pp. 66-89 thereof), in which we show that the prudent investment basis of rate regulation is sound and workable, that it is overwhelmingly supported by the great body of professional opinion, and that many experienced regulatory bodies have adopted and advocated its utilization. The principal advantages of the prudent investment base will merely be briefly recapitulated at this point.

(a) Prudent investment, in contrast to present value, can be determined expeditiously, accurately, and to a degree of exactness that leaves substantially little ground for conflict between the public and private interests. Once a prudent investment rate base has been determined, the re-determination of a rate base thereafter would amount to the relatively simple task of ascertaining net plant additions, an inquiry greatly facilitated by the use of the companies' books of account and its continuing property records. The importance to the public and to investors of the simplification of the administrative problems of regulation that would follow from the adoption of prudent investment as a rate base can hardly be exaggerated.

(b) An investment base is fair and just to the utilities. Practical experience in California, Massachusetts and elsewhere shows that this method has attracted the necessary capital and

has secured adequate service. A basis of rate regulation which maintains the Company's financial integrity and permits it to raise the required capital cannot be deemed arbitrary. See Brandeis, J., concurring in *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 291; Hale, *Conflicting Judicial Criteria of Utility Rates*, 38 Col. L. Rev. 959, 969-970.

(c) The investment base is fair to investors in the utility. The investor's contribution to public service is his capital, and he is treated equitably when he is allowed a compensatory return thereon. Public utilities usually finance a large part of their plant through issuance of bonds and preferred stocks, whose returns are contractual and fixed. Stability of investment and safety of principal are important factors to these investors.

A rate base predicated upon investment is the most stable type and is thus fair to such investors. Even as to common stock, stability of investment is obtained under prudent investment. It is merely necessary to adjust the rate of return to current costs of capital; indeed, such adjustment might well convert common stocks into gilt-edge investments, by protecting them from depreciation in value during time of depression.²⁶

²⁶ Under the rule of *Smyth v. Ames*, on the other hand, utility investors tend to receive both the benefit of appreciation in property values and protection against depreciation. This is so because in periods of deflation, regulatory agencies cannot undertake to fix values in strict conformity to *Smyth v. Ames* without throwing many utilities into receivership,

(d) State and federal regulation of utilities' accounts are giving increased reliability to investment figures. Appendix C to this brief (pp. 141-143 *infra*) lists the state commissions which control the issuance of securities and have prescribed accounting by utilities on an original cost or investment basis. See also *American Tel. & Tel. Co. v. United States*, 299 U. S. 232; *Alabama Power Co. v. Federal Power Commission*, 128 F. (2d) 280 (App. D. C.), certiorari denied, 317 U. S. 652; *Louisville Gas & Electric Co. v. Federal Power Commission*, 129 F. (2d) 126 (C. C. A. 6), certiorari denied, 318 U. S. 761.

The investment basis is the standard accounting practice used by business institutions in reporting their financial transactions to stockholders, banks and other interested parties. Because it combines

and this would, of course, deprive consumers of necessary utility service. Bonbright, *Merits of Original Cost and Reproduction Cost*, 41 Harv. L. Rev. 593, 621-622; see Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 423-424. "The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher." Brandeis, J., in *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 311. Since, under the practical operation of the *Smyth v. Ames* rule, the utilities are not compelled to suffer from a decline in values, it is not unreasonable to deny them the increase. And if some account must be taken of the factor of increasing prices as bearing upon the stability of investment, this may readily be accomplished by altering the rate of return. See Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419, 434-435; Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263, 273.

exactness, ease of application, and equitableness, it is the standard best adapted to modern business conditions and practices in this country.

(e) The prudent investment base is fair to consumers, by assuring them a sound and stable utility whose services will be rendered at the lowest rate consistent with the attraction of necessary capital and with a reasonable return to investors.

(f) The use of the prudent investment basis of rate regulation is the long-established practice of the Federal Power Commission,²⁷ and in 1940 it reported to Congress that its rate-making policy was to insist upon such a rate base (20th Annual Report of the Federal Power Commission, p. 62). Proof of the reasonableness of the method and its compliance with constitutional requirements is to be found in the fact that the Commission has obtained consent reductions in natural gas rates on this basis, exceeding \$9,600,000 annually.²⁸ Consent reductions would hardly have been forthcoming if rates based on prudent

²⁷ *Re Albany Lighting Co.*, 25 P. U. R. (N. S.) 36, 39; *Re Interstate Power Co.*, 32 P. U. R. (N. S.) 1, 10; *Los Angeles v. Nevada-California Electric Corp.*, 32 P. U. R. (N. S.) 193, 206; *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263; *Re Canadian River Gas Co.*, 43 P. U. R. (N. S.) 205, 224; *Detroit v. Panhandle Eastern Pipe Line Co.*, 45 P. U. R. (N. S.) 203; *Re Interstate Natural Gas Company*, 48 P. U. R. (N. S.) 267, 274.

²⁸ The \$3,750,000 interim rate reduction approved in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, was followed by a final consent rate reduction of an additional \$2,750,000 and was based on prudent invest-

investment had produced a return which the companies considered to be unreasonable and confiscatory.²⁹

The rule of prudent investment thus combines exactness, ease of application, and appropriateness for determining a return fair to the utility, investors and the public. It is the standard for rate making best adapted to modern business conditions and practices in this country. Since it is clearly reasonable and produces no arbitrary result, rate regulation on the basis of prudent investment is entirely consistent with due process, in addition to being well adapted to serve the Congressional objective of producing "just and reasonable" rates. Cf. *Nebbia v. New York*, 291

ment. F. P. C. Order Accepting Reduced Rates for Filing and Terminating Proceedings, September 19, 1942. Additional reductions on the prudent investment basis were obtained in the following cases: *Re Lone Star Gas Co.*, F. P. C. Docket Nos. G-208, G-209, May 4, 1942, Order Reducing Rates by \$2,053,564 annually; *Re El Paso Natural Gas Co.*, F. P. C. Docket Nos. G-424, G-257, October 29, 1942, Order Reducing Rates by \$526,000 annually; *Re Northern Natural Gas Co.*, Feb. 4, 1943, Order Making Effective Reductions in Rates by \$2,087,000 annually; *Re Louisiana P. S. Comm. v. United Gas Pipe Line Co.*, F. P. C. Docket Nos. G-133, G-148, G-157, G-193, April 16, 1943, Order Making Effective Reductions in Rates by \$2,195,287 annually.

²⁹ Under the Federal Power Act (Secs. 20 and 14), the rate base prescribed for licensed hydroelectric projects is the "net investment," which is the equivalent of prudent investment (41 Stat. 1077, 16 U. S. C. § 791). In twenty years, 128 major hydroelectric projects have been constructed at a cost of \$740,000,000 (20th Annual Report, F. P. C., p. 15).

U. S. 502, 537-539. There being no constitutional objection to prudent investment on the ground of reasonableness and no statutory restriction upon its use, the Commission should be permitted to adopt that formula. See *American Tel. & Tel. Co. v. United States*, 299 U. S. 232, 244; *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 606 (Black, Douglas, Murphy, J. J., concurring). And to eliminate any doubts as to the propriety of such a rate-making method, we suggest that the so-called rule of *Smith v. Apts.*, as enunciated in the *Southwestern Bell* case, should be renounced.

III

THE COMMISSION PROPERLY EXCLUDED FROM ACTUAL LEGITIMATE COST THE INTANGIBLE COSTS OF WELL DRILLING AND OTHER ITEMS PROPERLY CHARGED TO OPERATING EXPENSE PRIOR TO 1923 AND FULLY RECOUPED FROM RATEPAYERS

The Commission found that Hope's actual legitimate cost amounted to \$51,957,416 (before depreciation) for the property devoted to interstate sales as of December 31, 1940. The Commission declined to include in that figure an additional sum of about \$17,000,000,³⁰ consisting largely of expenditures by Hope and the com-

³⁰ This \$17,000,000 figure is before depreciation. After depreciation it amounts to about \$4,000,000 as the court below noted (R. IV, 184).

panies from which it acquired properties, for labor and drilling equipment used in drilling wells before 1923. These expenditures, until 1923, were charged to operating expenses in accordance with the general practice in the industry.³¹ The court below held the Commission's action improper, and ruled that these items must now be capitalized and reflected in the rate base, principally on the ground that they had been "erroneously charged to expense" instead of to capital (R. IV, 186-189). We believe that the ruling below embodies two fundamental errors: (1) the items in question were not in fact "erroneously" charged to expense; and (2) the decisions of this Court, principally *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 590-591, support the Commission's determination against capitalizing items, previously and properly treated as operating expenses and recovered from revenues received from ratepayers.

A. NATURE OF CONTESTED ITEMS

The actual legitimate cost of Hope's interstate properties, as determined by the Commission, was obtained by going to the books and records of the Company, which covered its entire history, and were complete and well kept. All necessary rec-

³¹ In 1923, the West Virginia Public Service Commission, pursuant to its jurisdiction over intrastate rates, required Hope to charge future expenditures for well-drilling to capital (R. I, 28).

ords had been preserved; there was therefore no occasion to resort to estimates. (R. I, 174; R. III, 25-30.) In determining Hope's actual legitimate cost the Commission accepted all of the Company's book figures, making adjustments for items which were clearly wrong and about which there is no dispute.³² The Commission thus adopted the accounting decisions of the Company's competent management made over a long period of years.

The "original cost" of Hope's interstate properties, as of December 31, 1938, as shown on the Company's books in the plant investment account, was \$52,730,666. However, Hope estimated its "original cost" at \$69,735,638. (R. I, 25, 197; Exh. 20, Statement B.) This figure, which is \$17,004,972 more than the amount shown on its own books, included: (a) Items which have been identified as expenditures charged to operat-

³² Two main adjustments were made to correct accounting errors. One reduced the cost, as shown by the books, by \$2,057,618 on account of retirements of property which had not been recorded in the books. The Company made this inventory adjustment to correct its books and the Commission accepted it. The other adjustment, which was recommended by the Commission's staff, would restore the amount of \$1,295,953 which had been arbitrarily written out of the plant accounts by the Company. (R. I, 35, 256-258.) The Commission observed that there was "considerable question" as to whether this item should be restored (R. I, 35), but because the arbitrary write-offs were contrary to sound principles of accounting, finance, and business administration, and likewise contrary to the practices of the gas industry, the \$1,295,953 was added to the book cost and included in the investment rate base.

ing expenses prior to December 31, 1938. Chief among these, and the largest item of difference between the Commission and Hope as to cost of plant, were expenditures for well-drilling amounting to \$12,643,641. This was composed of \$11,279,554 for wells drilled prior to 1923 by the Company itself, and \$1,364,087 for wells drilled prior to 1923 by companies whose properties were acquired by Hope (R. I, 195; Exh. 20). Such expenditures were for labor, use of drilling-rigs, hauling, and similar costs—all known to the industry as “intangible well costs.” They do not cover the cost of well equipment items, such as casing and tubing, which were included by the Commission in the “original cost.” (b) Items for amounts that were never expended, such as interest during construction (\$632,000), for which no charges were ever incurred. (R. I, 24, 180.) (c) Items which the Commission has already included in the rate base.³³

Hope reached its estimate of “original cost” by ignoring its past accounting practice, instead making an inventory of all its properties, and then pricing the inventory according to prices obtained from vouchers and other documents and from engineer’s estimates (R. II, 178–185, 201, 204–210).

The Commission refused to include these well-drilling and related costs in the rate base on the ground that those expenditures had been cor-

³³ The failure of the court below to notice this breakdown (R. IV, 184) was apparently an inadvertence.

rectly charged to operating expenses by the Company in accordance with the general practice of the industry; that they have already been recouped from Hope's customers; and that to include them in the rate base would result in duplicate charges (R. I, 26-29.³⁴ This accorded with the Commission's settled practice of accepting, in the process of determining cost or investment, books kept in the regular course of business, subject to the correction of errors found therein.

The majority below held that the entire \$17,000,000 must now be capitalized and (less accrued depreciation) reflected in the rate base, because the items, "erroneously charged to expense" instead of to capital by the Company, "represent investment by the company in property which it uses in rendering the service for which rates are prescribed" (R. IV, 184-185, 189).

We submit that the court erred because (1) the items in question were properly charged to expense, and (2) since Hope has been reimbursed for them out of operating expenses, they do not represent investment on which Hope is entitled to a return. Since the intangible costs of well-drilling constitute more than \$12,500,000 of the \$17,000,000 involved, and present Hope's

³⁴ Although the Commission's present System of Accounts provides for the capitalization of such costs, it explicitly prohibits the reaccounting for items properly charged to expense in the past (R. I, 234-238; Ex. 58; R. III, 48).

contentions in their most favorable light, the following discussion and analysis will be in terms of these costs.

B. PRIOR TO 1922, HOPE INTENTIONALLY AND PROPERLY CHARGED
WELL-DRILLING COSTS TO OPERATING EXPENSES

As the Commission found in accordance with the evidence, it was Hope's "consistent practice * * * up to 1923 to charge the cost of drilling wells to operating expense" (R. I, 27, 251-254; R. II, 173-177, 181). This reflected the almost universal practice not only of natural gas companies but of all extractive industries (R. I, 276-277), as Hope's chief accounting officer, who had been with the Company for many years, and the Commission's witnesses testified (R. II, 173-174; R. I, 253-256). Thus, in 1919, the Natural Gas Association of America opposed a provision in the first Uniform System of Accounts for Natural Gas Companies requiring the classification of well-drilling expenditures as plant costs, basing its opposition on the ground that such expenditures were incurred to maintain the business rather than to add to it (R. I, 255). And in 1921, Hope itself contended before the Public Service Commission of West Virginia that well-drilling costs should be treated as expense, and succeeded in obtaining permission so to charge them, thereby raising its rates to local consumers. *Re Hope Natural Gas Company*, P. U. R. 1921 E, 418, 433, 440. In that ruling the West Virginia

Commission observed that the failure of natural gas companies to capitalize well-construction expenses was commonly explained as follows: Since drilling expenses are incurred in an attempt to maintain sufficient gas production to meet demands, and since "notwithstanding such drilling, its available supply of gas is constantly and rapidly decreasing each year, * * * at least a part of the cost of maintaining this failing supply should be borne by consumers for the period within which such additional investment is made." *Re Hope Natural Gas Co.*, P. U. R., 1921 E, 418, 440.

However, in 1922, scarcely more than a year after its decision, the State commission issued a Uniform System of Accounts for all natural gas companies subject to its jurisdiction, including Hope, requiring them to charge expenditures for well-drilling to capital on and after January 1, 1923 (R. II, 174; R. I, 28). Hope accordingly changed its accounting procedure for these expenditures, not to correct any error, but rather to comply with the uniform system of accounts, to promote uniformity in the future. This change in accounting also recognized the progress then being made in gas and oil exploration and in drilling methods, which was bringing about the discovery of huge resources formerly unknown and unavailable and thus was removing the fear of rapid decrease in supply—the *raison d'être* of the former accounting procedure.

The propriety of Hope's accounting procedure up to 1923, as to well-drilling items, has been recognized by the Bureau of Internal Revenue. Questions as to the proper treatment of these expenditures have arisen under Section 212 (b) of the Revenue Act of 1918 (40 Stat. 1057, 1064-1065), which provided generally that the taxpayer's method of keeping books was to be accepted by the Commissioner of Internal Revenue, unless he found that method to be wrong. Under this provision, the Commissioner has allowed the taxpayer the option of capitalizing such items or charging them as ordinary and necessary operating expenses, provided that consistency is maintained. Income Tax Regulations, Reg. 103, Secs. 19.23 (m)-15 (b) (3); 19.23 (m)-16 (a) (1). This tax rule is still in effect, and most natural gas companies, including Hope, continue to charge such expenditures as operating expenses for income tax purposes (R. I, 255; R. II, 176).³⁵

Since the intangible costs of well-drilling incurred prior to 1923 had already been properly charged by Hope to operating expenses, the Com-

³⁵ Even today, some oil companies still follow the practice of charging the intangible costs of well-drilling to operating expense for general accounting purposes (R. I: 254-256). This is in accordance with the general policy of conservatism, adhered to in extractive businesses, which frequently charges to expense items which in other industries would be charged to capital (R. I, 256). Cf. *Marsh Fork Coal Co. v. Lucas*, 42 F. (2d) 83 (C. C. A. 4); *Commissioner of Internal Revenue v. Brier Hill Collieries*, 50 F. (2d) 577 (C. C. A. 6).

mission properly refused to permit Hope now to renounce its own voluntary accounting practice, and to present the same items as capital expenditures in order to derive the benefit of an increased rate base.

C. THE WELL-DRILLING COSTS WERE FULLY RECOVERED THROUGH RATES AND SHOULD NOT NOW FORM A BASE FOR FURTHER ANNUAL RETURN

As we have shown, the practice of charging well-drilling costs directly to expense was common to the whole gas industry, and represented a managerial decision as to allocation of expenditures. Such a decision, like other managerial determinations as to allocation of costs, affects the operating figures of the utility and is bound to be reflected in the rates. Certainly Hope in fixing rates was influenced by the common managerial desire to recover all its costs, and these, prior to 1923, included well-drilling expenses. Indeed, the inclusion of these expenses was one of the means which Hope utilized to obtain a higher rate to consumers in West Virginia in 1921.³⁶ There can be little

³⁶ Even during the unregulated period, Hope as a public utility was required by the common law not to charge more than a just and reasonable rate. *Munn v. Illinois*, 94 U. S. 113, 126-127, 133; *Chicago, B. & Q. R. R. Co. v. Iowa*, 94 U. S. 155, 162. And the local commission could scrutinize the charges from Hope to the intrastate utilities in order "to prevent imposition upon the community served by the latter" (cf. *Houston v. Southwestern Tel. Co.*, 259 U. S. 318, 323), or in order to ascertain whether there is bad faith. Cf. *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 288.

doubt, therefore, that during the period when Hope was charging the costs of well-drilling to operating expenses, that is from the Company's inception in 1898 up to 1923, Hope fully recouped the costs of well drilling. During this 25-year period, Hope was earning an annual average return of 15% on its average invested capital³⁷ (R. I, 34; R. III, 13-14), which is, of course the return after meeting all annual operating expenses including well-drilling costs.

The decision of this Court in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, is in fact dispositive of this question, as was pointed out by the dissenting judge below (R. IV, 205-207). In the *Pipeline* case, involving an interim rate order under the Natural Gas Act, the Commission, solely for the purpose of that order, had "reluctantly" accepted as the rate base the Company's estimate of the value of all physical property—including excess capacity—calculated at reproduction cost new. The Company, however, sought to include in the rate base, *inter alia*, the costs of maintaining the excess capacity during the unregulated period, costs which had already been charged to operating expense. This the Commission rejected, and its determination was approved by this Court. The rationale expressed in the opinion (315 U. S. at 590-591) is closely

³⁷ The term "invested capital" is used to include capital stock and earned surplus. Hope's entire capital structure consists of common stock.

apposite here: Since the Company had treated these items as operating expenses to be compensated from earnings, and since the history of the Company before regulation showed an average annual return of 8% on the undepreciated investment, it could not be said "that the Commission has deprived the companies of their property by refusing to permit them to earn for the future a fair return and amortization on * * * costs which the companies fail to show have not already been recouped from earnings before computing the substantial 'net profits' earned during the first seven [unregulated] years." [Italics supplied.] This Court found it significant that the Company had "charged the out-of-pocket cost of maintenance of plant * * * as operating expenses deductible from net earnings before arriving at net profits", and pointed out the want of a showing "that the items which have never been treated as capital investment, have not been recouped during the unregulated period." See, also, *Natural Gas Co. v. Public Service Commission*, 95 W. Va. 557, 571, 121 S. E. 716, 723; *Peoples Gas Light & Coke Co. v. Slattery*, 373 Ill. 31, 25 N. E. (2d) 482, 493, appeal dismissed, 309 U. S. 634.³⁸

³⁸ In addition to the cases quoted, *supra*, the following also prohibit reaccounting and support the principles employed by the Commission.

Los Angeles Gas & Electric Corp. v. R. R. Comm'n, 58 F. (2d) 256, 261, 267. (S. D. Cal.), affirmed, 289 U. S. 287; *North-*

As was true of the Company in the *Pipeline* case, Hope charged the items in question to operat-

Western Electric Co. v. Federal Power Commission, 125 F. (2d) 882, 887 (C. C. A. 9); cf. *Helvering v. Wilshire Oil Co.*, 308 U. S. 90, 95, 97-99; *Chicago & N. W. R. Co. v. Commissioner of Internal Revenue*, 114 F. (2d) 882, 886, certiorari denied; 312 U. S. 692.

A large number of rate-making bodies take the same view. *Elgin, Joliet & Eastern Ry. Co.*, 84 I. C. C. 587, 592; *Re Northwestern Electric Co.*, 36 P. U. R. (N. S.) 202, 208; *Re Canadian River Gas Co.*, 43 P. U. R. (N. S.) 205, 214; *San Francisco v. Pacific Gas & E. Co.*, P. U. R. 1918A, 506, 521; *Re Los Angeles Gas & E. Corp.*, P. U. R. 1931A, 132, 143; P. U. R. 1933E, 317, 323; *Re Leadville Water Co.*, P. U. R. 1921D, 172, 183; *Re Potomac Electric Power Co.*, P. U. R. 1917D, 563, 606; *Re Hawaiian Electric Co. Ltd.*, 33 P. U. R. (N. S.) 161, 165; *Re Kootenai Power Co.*, P. U. R. 1924E, 831, 833; *Illinois Commerce Comm'n v. Pub. Serv. Co. of No. Illinois*, 4 P. U. R. (N. S.) 1, 21; *Illinois Commerce Comm'n v. Commonwealth Edison Co.*, 15 P. U. R. (N. S.) 404, 405; *Re Peoples Gas Light & Coke Co.*, 19 P. U. R. (N. S.) 177, 196; *Re Indianapolis Water Co.*, P. U. R. 1919A, 448, 479; *Re Central Maine Power Co.*, P. U. R. 1918C, 792, 796; *Re Eaton Rapids*, P. U. R. 1922D, 94, 104; *Re West St. Louis Water & L. Co.*, P. U. R. 1922E, 805, 819; *Aluminum Goods Mfg. Co. v. Laclede Gas Light Co.*, P. U. R. 1927B, 1, 14; *Pub. Serv. Comm'n v. Montana P. Co.*, P. U. R. 1924B, 364, 372; *Hegmann v. Newton Gas Co.*, P. U. R. 1916D, 825, 843; *Moritz v. Edison Electric Illum. Co.*, P. U. R. 1917A, 364, 390; *Maries v. Flatbush Gas Co.*, P. U. R. 1920E, 930, 1004; *Re New York State Rys.*, P. U. R. 1922B, 75, 79; *Re Westchester Lighting Co.*, 15 P. U. R. (N. S.) 299, 310; *Re Brooklyn Borough Gas Co.*, 21 P. U. R. (N. S.) 353, 371; *Public Util. Comm'n v. Duquesne Light Co.*, 20 P. U. R. (N. S.) 1, 10; *Pub. Util. Comm'n v. Peoples Natural Gas Co.*, 43 P. U. R. (N. S.) 82, 109; *Re Clarksburg Light & H. Co.*, P. U. R. 1917A, 577, 598, P. U. R. 1928B, 290, 296; *Re West Virginia Central Gas Co.*, P. U. R. 1918C, 453, 464, P. U. R. 1924E, 24, 34; *Re Mondovi Telephone Co.*, P. U. R. 1923B, 319, 321, P. U. R. 1933D, 142, 144; *Re Reedsburg Telephone Co.*, 7

ing expenses, received a substantial return on its investment, and has not shown that the items were not fully recovered. Since Hope is unable to show "with the clarity and definiteness befitting the cause" (*Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 164, 169; *Los Angeles Gas Co. v. R. R. Comm'n*, 289 U. S. 287, 304, 305; *St. Joseph Stock Yards Co. v. United States*, 298 U. S. 38, 53) that these expenditures "have not already been recouped from earnings," the Commission's refusal to permit Hope to earn for the future a fair return and depreciation on these expenditures cannot be said to deprive it of its property. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 590, 591; *Des Moines Gas Co. v. Des Moines*, 238 U. S. 153, 166.

The ground upon which the court below held that these costs belong in the rate base, was that (R. IV, 185) "the wells are existing property used by the utility in its service to the public. The items entered into their cost just as truly as if they had been charged to capital account" (quoting Mr. Justice Brandeis' definition of original cost as "the amount actually paid to establish the utility." *Southwestern Bell Telephone Co. v. Public Service*

P. U. R. (N. S.) 389, 395. See also *Statement Relating to the Original Cost and Reclassification of Utility Plant Pursuant to the Provisions of Uniform Systems of Accounts for Electric, Gas and Water Utilities*, by the Committee on Statistics and Accounts of the National Association of Railroad and Utilities Commissioners, September 20, 1940.

Commission, 262 U. S. 276, 295). This reasoning, however, confuses cost with return, and overlooks the basic principle that Hope is entitled to a return only on that part of costs which have not been and are not currently being returned to it through operating expenses. The intangible costs of well drillings may be part of Hope's costs in establishing the utility, but Hope is entitled to a return on those costs only so long as its investment therein has not been fully recouped. There is no principle which would entitle it to a continuing return on an item of property whose cost has been fully recovered from the rates received, and which thus does not represent an investment, even though the property involved remains in use.

The effect of Hope's practice of charging the intangible well-drilling costs to operating expense was to require the customers to pay not only for the current service being rendered to them but also to contribute the amount of these costs to the capital of the company. Cf. *Re West Virginia Central Gas Co.*, P. U. R. 1924 E, 24, 34-35. Since the customers have in effect financed these well-drilling expenditures, their capitalization in the rate base would violate the long-established rule that a utility should not be permitted a return on property constructed and financed with customer contribution. (*Louisiana R. R. Comm. v. Cumberland Tel. & Tel. Co.*, 212 U. S. 414, 424, *et seq.*; cf. *Lindheimer v. Illinois Bell Telephone Co.*, 292

U. S. 151, 169, 174; *Detroit Edison Co. v. Commissioner of Internal Revenue*, 319 U. S. 98). And since it is "the actual cost of the property—the investment the owners have made" (*Los Angeles Gas Co. v. R. R. Comm'n*, 289 U. S. 287, 306) with which we are here concerned, it was proper for the Commission to forbid the capitalization of these items.

Contrary to the view of the court below, there is nothing in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U. S. 23, which prohibits the Commission from excluding intangible well-drilling costs from the rate base. In that case, the Public Utility Commission found that the Telephone Company had been taking excessive annual depreciation allowances, and the Commission attempted to absorb such excess by imposing rates which would reduce the prospective depreciation allowances of the Company below the *actual* rate of depreciation. This Court thought this to be error, holding that "the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations. Profits of the past cannot be used to sustain confiscatory rates for the future" (271 U. S. at 32).

That case is plainly inapplicable here. The Commission has not attempted here to impose prospective confiscatory rates in order to absorb past excessive profits; it has merely refused to allow Hope to capitalize expenditures already

recouped and thereby prospectively to earn excessive profits through an annual return and depreciation allowance on such expenditures. The *New York Telephone* case involved an order by the regulatory body directing "the company to make up current losses out of reserves accumulated from the past"; it raised no question "in regard to including property in the rate base which had theretofore been paid for out of operating expenses." *Wheeling v. Natural Gas Co.*, 115 W. Va. 149, 160, 175 S. E. 339. The distinction is between a rate producing less than a fair return in order to equalize past excessive profits, which was presented in the *Telephone* case, and a rate producing a fair return on investment from which fully recouped items have been excluded in order to prevent future excessive profits, which we believe is presented here.

The *Telephone* case is not apropos for an additional reason. Since its effect is to enable the Company to accumulate more than sufficient to replace the property at the end of its service life and thereby earn more than a fair return, the rule of that case would not apply to "wasting asset businesses of limited life," such as the natural gas industry, for there "the Constitution does not require that the owner * * * shall receive at the end more than he has put into it." *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. at 593.

D. PRACTICAL CONSIDERATIONS SUPPORT THE COMMISSION'S EXCLUSION OF THESE ITEMS FROM THE RATE BASE

As a practical matter, it is fundamental to effective rate regulation that a proper decision once made as to accounting policy be binding as to all past transactions thereunder. In utilities as in other enterprises, lines of demarcation, although clear in theory, are frequently "difficult * * * to observe in practice with scientific precision" (*Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 173), and, therefore, much discretion must be exercised even with accepted principles and practices as guides.

For example, there are items in the Commission's present System of Accounts whose treatment is borderline. The costs of exploration and development, as an illustration, are treated as current expenses. Such costs, involving expenditures for delay rentals, nonproductive well-drilling, and related matters, are necessary to maintain production. The Chief of the Commission's Bureau of Accounts, Finances and Rates testified that there was considerable support in accounting theory for capitalizing such expenditures, but because the practice of the industry was to treat them as expenses, he recommended that the Commission approve that method. (R. I, 259-260.) The Commission consequently allowed \$600,000 as annual expenses for exploration and development (R. I, 53-54, 65), and Hope has raised no objection thereto. But if it is successful in its claim

for the retroactive capitalization of well-drilling expenditures, there is no reason why similar claims could not be successfully prosecuted in a future rate case to capitalize exploration and development costs which are now allowed as expenses. And over a period of years the latter costs would greatly exceed the well-drilling costs. Again, under the Commission's System of Accounts, Hope may elect to charge administrative and general costs to expenses, or to capitalize them. Hope informed the Commission that it chose the former alternative; hence the Commission allowed the Company \$138,018 in 1940 operating expenses (R. I, 49-50). It would be manifestly wrong to permit Hope to capitalize the same costs in some future rate case.

To permit renunciation by a company of its own accounting practice would invite juggling of items many years after their occurrence, in any manner likely to benefit the utility. For example, in asserting a right to capitalize the well-drilling expenses here involved, Hope rejects its own past accounting practice of many years' standing, impeaches its books kept competently for a long period of years, nullifies the decisions of its management, and impugns financial statements and reports properly and correctly made by the Company in the past to the tax authorities, to regulatory commissions, and to the public generally (R. I, 31; R. II, 173-176). It substitutes the figures of a specially engaged witness, who

admittedly knows nothing about the practices and policies of Hope or the industry (R. II, 178-370). Mr. Antonelli, who was the Company's "expert" on this subject, admitted that he was not an accountant, that he was unfamiliar with the operations of the Company, and that he was not concerned with the accounting practices of the Company nor with its management's decisions or policy in the past regarding the classification of expenditures between operating expenses and plant (R. II, 315).³⁹ It is this calibre of expertise which, if the Commission's action is overturned, would be invoked to resuscitate ancient items charged to operating expenses, and to tender them as items of capital for which the rate payer must pay an annual charge.

E. REMAINING ITEMS EXCLUDED FROM THE RATE BASE

The remaining items, totalling some \$4,500,000, which the Commission excluded from original cost, were made up of overhead charges and minor items of property. The former arise largely from the exercise of *nunc pro tunc* judgment in the allocation of expenditures between plant-investment and expenses. There is even less reason for permitting readjustment here than in the case of items which are at least arguably related to capital investment.

³⁹ Even he was obliged to admit on cross-examination that the retroactive capitalization of such items was improper (R. II, 326-327).

The minor property items consist largely of the estimated cost of minor structures, such as sheds and toolhouses, for which separate accounting entries were not made. This accorded with proper accounting standards, for these items were not separately identified in the plant investment account and were merely subsidiary to main structures which were so identified (R. III, 32). The items in question have been charged either to investment or expense. If to investment, they are already in the rate base, although not so identified. If to expense, they were properly treated as expendable and should not be included in the rate base for the reasons discussed above in connection with well-drilling expenses.

As for the item of \$632,000, consisting of interest during construction which was never incurred, little need be said. Even in reproduction cost estimates, this Court has approved the disallowance of hypothetical costs which were never incurred by the utility. *Los Angeles Gas Co. v. R. B. Comm'n*, 289 U. S. 287, 310; *Wabash Valley Electric Co. v. Young*, 287 U. S. 488, 500.

IV

THE COMMISSION PROPERLY USED THE ECONOMIC-SERVICE-LIFE PRINCIPLE IN DETERMINING ACCRUED DEPRECIATION AND DEPLETION

In determining the proper rate base, the Commission first computed the original cost of Hope's

interstate properties, and then deducted therefrom the accrued depreciation. The Commission rejected, as being without merit, the observed-depreciation method employed by the Company, and instead applied the economic-service-life principle to the cost of the property, resulting in a figure of \$22,328,016 for accrued depreciation and depletion (R. I, 10, 45, 50).

The lower court condemned these findings of the Commission on the grounds that they were based on cost rather than present value of the property, and that they neglected the actual condition of the property for "theoretical formulas" (R. IV; 189).

At this point we argue that the formulas condemned by the lower court are in accord with the accepted views as to the nature of depreciation and the proper method of accounting therefor. The propriety of the cost basis used for this purpose is discussed in detail in Point V of this brief, pp. 99-108 *infra*.

The economic-service-life principle for determining accrued depreciation reflects the view, now accepted by almost all informed opinion, that depreciation is the diminution of the service capacity of the property or, in terms of the monetary measure of the original service capacity, the diminution in service value. See *Proceedings of the National Association of Railroad and Utilities Commissioners*, 1938, pp. 441-443; *id.* 1943 (Report of Committee on Depreciation) p. 30; *Depre-*

ciation Charges of Telephone and Steam Railroad Companies, 177 I. C. C. 351, 372-382. This is the uniform conclusion of all rate-making agencies, both federal and state.⁴⁰ It is also the view

⁴⁰*Uniform System of Accounts for Natural Gas Companies* promulgated by the Federal Power Commission, effective January 1, 1937, defines depreciation as "the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in the case of natural gas companies, the exhaustion of natural resources." Service value is defined as "the difference between original cost and net salvage value." See also *Uniform System of Accounts for Class A and Class B Telephone Companies* promulgated by the Federal Communications Commission, effective January 1, 1937; *Uniform System of Accounts for Electric Utilities* promulgated by the Federal Power Commission, effective January 1, 1937; *Uniform System of Accounts for Electric Utilities* recommended by the National Association of Railroad and Utilities Commissioners (1936); *Uniform System of Accounts for Natural Gas Companies* recommended by the National Association of Railroad and Utilities Commissioners. Twenty-seven States have adopted the Federal Communications Commission system for Class A and Class B telephone companies identically; eight have adopted it substantially; no system is prescribed in the other States. See Federal Communications Commission Release, August 18, 1941, *Accounting Systems Prescribed by the States for Use of Telephone Companies*. Similar systems have been adopted by the majority of States for electric and gas utilities. See *State Commission Jurisdiction and Regulation of Electric and Gas Utilities*, published by the Federal Power Commission, January 1941, pp. 11, 35.

expressed by this Court in *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 167. This view of depreciation is based on the simple principle that the economic value of property—its ability to earn a return—consists of the total units of useful service which it is capable of producing. Thus, investments are made in physical property solely because of the economic service which it will render, and the investments represent cost of stored-up services. It is the using up of these economic services, referred to as service capacity, service life, or economic life, that is depreciation (R. I, 375-377). Paton and Littleton, *An Introduction to Corporate Accounting Standards*, p. 84; Porter and Fiske, *Accounting*, p. 406; Taussig, *Principles of Economics*, Vol. I, p. 70; *Proceedings of the National Association of Railroad and Utilities Commissioners* (1938) pp. 44-445; *id.* (1943) p. 91; *Depreciation Charges, of Telephone and Steam Railroad Companies*, *loc. cit. supra*, pp. 90-91.

The annual depreciation is thus the amount of the service capacity which has been consumed in any one year. Such consumption is as much a cost of operation as fuel or any other property which is totally consumed, physically and economically, during the year; and the annual depreciation cost is thus an operating charge properly to be met from current revenues. Cf. *Illinois Central Railroad v. Interstate Commerce Commission*, 206 U. S. 441, 462.

It is for this reason that in fixing reasonable rates there should be included in "operating expenses, that is, in the cost of producing the service, an allowance for consumption of capital * * *." *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 167.

The main purpose of depreciation accounting is to determine as accurately as possible the cost of property consumed in operations during a given period such as a year. The annual allowance for depreciation therefore compensates for the economic consumption of capital during that year and maintains the integrity of the investment in the service rendered. The reserve requirement on any selected date should be a measure of the extent to which the service lives of the properties have expired and therefore is properly the total of the annual provisions for depreciation less actual retirements of property. The preferred depreciation method is known as the "straight-line-basis". See

Report of the Committee on Depreciation, National Association of Railroad and Utilities Commissioners, 1943, p. 91.

The method is equally applicable to both depreciation and depletion, and to ascertain the depreciation and depletion reserve requirements of Hope, the Commission utilized this "straight-line-basis". The Commission obtained estimates of the over-all or average service lives of the property by classes, from a qualified staff engineer who made a detailed inspection of the present

physical condition of the property as an aid to these determinations (R. I, 42; R. III, 157-158);⁴¹ those average service lives were converted into depreciation rates and then applied to the "service value" of the property⁴² to determine the por-

⁴¹ The lower court, in condemning the Commission's findings as to accrued depreciation for allegedly failing to reflect the present condition of Hope's properties (R. IV, 189-193), overlooked this inspection of these properties. As pointed out in the minority opinion, the consideration given to present condition "as a guide for estimating the property's service life" and the annual depreciation expense to be allowed, is clearly adequate (R. IV, 205). *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 593-595; see Brief for the Federal Power Commission and Illinois Commerce Commission, Nos. 265 and 268, October Term, 1944, p. 86 *et seq.* Moreover, there is substantial evidence in the record to show that studies were made of Hope's retirement experience and maintenance policies over its entire history, to aid in the determination of accrued depreciation (R. III, 158 *et seq.*). Cf. *Depreciation Charges of Telephone and Steam Railroad Companies*, 177 I. C. C. 351, 400-408; *Smith v. Illinois Bell Tel. Co.*, 282 U. S. 133. The resulting determinations thus "meet the controlling test of experience." *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 170.

⁴² The depreciation rates are not applied to the original cost of the property, but rather against its "service value." The latter is determined by subtracting from original cost the salvage value of the property, that is, the amount which would be received for property retired after the expiration of its service life (R. III, 155). Thus property which cost \$1,000 originally, with a salvage value of \$100 at the expiration of its full service life, would have a "service value" of \$900. Hence, if 90% of its service life has expired, the property would be valued at \$190 (i. e., 10% of its service value, or \$90, plus its ultimate salvage value of \$100). Nevertheless, the lower court found that the Commission had in some cases determined depreciated value to be less

tion of the cost which had expired in rendering service (R. I, 41-43; R. III, 157-174, 184-197). To illustrate the application of this formula to compute depreciation and depletion: If a well which will produce 10,000,000 M. C. F. during its life had already produced 1,000,000 M. C. F., 1/10 of the investment in such production facilities has been consumed in operation, requiring that 1/10 of its cost be recorded as an expense, and be deducted from cost as depreciation. So also, if a pipeline which will last 20 years had been in use for one year, 1/20 of its economic life is considered expired; accordingly, 1/20 of the cost should be recorded as an expense and deducted from the cost of the pipeline as depreciation.⁴²

than "salvage value." Aside from the mathematical impossibility of such a result, the so-called "salvage value" used by the lower court represented the value of property "when removed from its wells or lines and held for further use" (R. IV, 189). The application of the term "salvage" to the value of such property is a misnomer, for since its service life had not expired, its value at that time represented more than salvage value. Moreover, in condemning the Commission's results, the court relied on figures obtained from Hope's "per cent condition" study, which had already been demonstrated by the Commission to be defective and unreliable (R. I, 37-38). Cf. *Los Angeles v. Southern California Telephone Co.*, 14 P. U. R. (N. S.) 252, 273; *Re Rochester Gas & Electric Corp.*, 33 P. U. R. (N. S.) 393, 468-490; 1 Bonbright, *The Valuation of Property*, 205.

⁴² As a natural consequence of these methods, depreciation expense and accrued depreciation are harmonized. Failure to insist on such correlation frequently results in depreciation reserve in excess of the amount required to restore or

The formula used by the Commission to determine accrued depreciation and depletion and annual allowance therefor has been analyzed and approved by this Court. *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 167, 168; *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575. The latter decision specifically approved use by the Commission, under the Natural Gas Act of the so-called amortization method of depreciation, and upheld an "annual amortization allowance [which] if applied over the entire twenty-three-year life of the business, is sufficient to restore the total capital investment, at the end," from earnings. 315 U. S. at 594."

The formula espoused by the Commission finds a wealth of administrative and expert support. The Interstate Commerce Commission and the Bureau of Internal Revenue have also approved the

replace the equipment. *Louisiana R. R. Comm. v. Cumberland Tel. & Tel. Co.*, 212 U. S. 414; *Lincoln Gas Company v. Lincoln*, 223 U. S. 349; *Clark's Ferry Co. v. Commission*, 291 U. S. 227; *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151; *St. Joseph Stock Yards Co. v. United States*, 298 U. S. 38; *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575.

⁴⁴ Fundamentally, both amortization as used by the Commission in the *Pipeline* case, and straight line depreciation as used by the Commission in the instant case, involve application of the economic-service-life principle. There is likewise no difference in the ultimate result. See Bauer & Gold, *Public Utility Valuation*, p. 199 *et seq.*; Barnes, *The Economics of Public Utility Regulation*, p. 263 *et seq.*

"straight-line" depreciation method.⁴⁵ The Special Committee on Depreciation of the National Association of Railroad and Public Utilities Commissioners has recommended it for accounting and regulatory purposes because it is practical and "equitable to the utility, the customer and the in-

vestor." Report of Committee on Depreciation, National Association of Railroad and Utilities Commissioners (1943) p. 91. And most

proval of the courts, the Commission's methods of determining actual accrued depreciation and depletion.⁴⁶

⁴⁵ *Depreciation Charges of Telephone and Steam Railroad Companies*, 177 I. C. C. 351, 408, 413. The Bureau of Internal Revenue sanctions the straight-line and unit-of-production methods, because they are accurate, simple, self-correcting, administratively desirable and facilitate verification. U. S. Treasury Department, Bureau of Internal Revenue, Bulletin "F" (January 1931, revised January 1942), pp. 4-5.

⁴⁶ *Joplin Gas Co. v. Public Service Commission*, 296 Fed. 271, 278 (W. D. Mo.); *New York Telephone Co. v. Prendergast*, 36 F. (2d) 54, 66 (S. D. N. Y.); *International Railway Co. v. Prendergast*, 1 F. Supp. 623, 629 (W. D. N. Y.); *Pacific Gas & Electric Co. v. Derlin*, 203 Pac. 1058, 1062 (Cal.); *State ex rel. Oregon-Washington Water Service Co. v. Hoquiam*, 286 Pac. 286, 290 (Wash.); *Long Island Lighting Co. v. Maltbie*, 292 N. Y. S. 807, 809 (App. Div.); *Yonkers Railroad Co. v. Maltbie*, 296 N. Y. S. 411, 416 (App. Div.); *Depreciation Charges of Telephone and Steam Railroad Companies*, 118 I. C. C. 295, 356; *Re Interstate Power Company*, (F. P. C.) 32 P. U. R. (N. S.) 1, 11; *Re Chicago District Electric Generating Corp.*, (F. P. C.) 39 P. U. R. (N. S.) 263, 275; *Re Canadian River Gas Co.*, (F. P. C.) 43 P. U. R.

If additional argument were needed to justify the Commission's depreciation and depletion formula, it is to be found in the fact that Hope had set up in its reserve for depreciation and depletion an amount (\$45,930,668) which was substantially greater than the actual depreciation and depletion as determined by the Commission in accordance with the straight-line method.⁴⁷

(N. S.) 205, 219; *Detroit v. Panhandle Eastern Pipe Line Co.*, (F. P. C.) 45 P. U. R. (N. S.) 203; *Re Los Angeles Gas & E. Corp.*, (Cal.) P. U. R. 1931A, 132, 152; *Re Hawaiian Electric Co. Ltd.*, (Ha.) 33 P. U. R. (N. S.) 161, 170; *Louisiana Pub. Serr. Comm. v. Southern Bell Tel. & Tel. Co.*, (La.) 8 P. U. R. (N. S.) 1, 12; *Re Central Light & Power Co.*, (N. D.) 37 P. U. R. (N. S.) 106, 112; *Re Northwestern Bell Telephone Co.*, (Neb.) 11 P. U. R. (N. S.) 337, 345; *Re Upstate Telephone Corp. of N. Y.*, (N. Y.) 13 P. U. R. (N. S.) 134, 153; *Re New York Telephone Co.*, (N. Y.) P. U. R. 1926 E, 1, 39; P. U. R. 1930C, 325, 337, 345; 14 P. U. R. (N. S.) 443, 448; *Re Long Island Lighting Co.*, (N. Y.) 18 P. U. R. (N. S.) 65, 137, 191; *Re Rochester Gas & Electric Corp.*, (N. Y.) 33 P. U. R. (N. S.) 393, 489, 503; *Re Southwestern Bell Telephone Co.*, (Okla.) 9 P. U. R. (N. S.) 113, 138; *Re Northwestern Electric Co.*, (Ore.) P. U. R. 1933A, 493, 512. See also Report of the Federal Communications Commission on the Investigation of the Telephone Industry in the United States, House Document No. 340, 76th Cong., 1st Sess., p. 347 (1939); Wheat, *The Regulation of Interstate Telephone Rates*, 51 Harv. L. Rev. 846, 866 (1938); Mason, *Principles of Public Utility Depreciation*, p. 103 (1937); *Depreciation—A Review of Legal and Accounting Problems*, Wisconsin Public Service Commission, pp. 109-121 (1933); 2 Bonbright, *The Valuation of Property* (1937), p. 1140; Proceedings of National Association of Railroad and Utilities Commissioners (1938), pp. 472-474.

⁴⁷ Hope, by the end of 1940, had accumulated a depreciation reserve of \$45,930,668 (including \$7,552,918 transferred to

Inasmuch as the amount found by the Commission came to some \$24,000,000 less than the reserve accrued on Hope's books—a reserve representing Hope's own judgment as to the amount of investment which has been returned on account of depreciation and depletion—the Commission's result is hardly arbitrary or confiscatory.

V

THE COMMISSION PROPERLY USED A PRUDENT INVESTMENT BASE IN DETERMINING THE ANNUAL ALLOWANCE FOR DEPRECIATION AND DEPLETION

Applying the economic-service-life principle discussed above to the cost of Hope's properties, the Commission recognized an annual depreciation and depletion allowance of \$1,460,037 as an operating expense (R. I, 36-45, 51-53). That annual

surplus). (R. I, 81; R. III, 176). The Commission, however, deducted only \$22,328,016, roughly \$24,000,000 less. One of the Commissioners dissented, asserting that the full amount accrued by the Company should be deducted. *New York Telephone Co. v. Prendergast*, 36 F. (2d) 54, 66 (S. D. N. Y.); *Re Southwestern Bell Tel. Co.*, 9 P. U. R. (N. S.) 113, 118, 138, affirmed, 71 P. (2d) 747, 751; *Louisiana Pub. Serv. Comm. v. Southern Bell Tel. & Tel. Co.*, 8 P. U. R. (N. S.) 1, 12, affirmed, 174 So. 180, 189; *Re Northwestern Electric Co.*, P. U. R. 1933 A, 493, 512. However, the Commission's action is consistent with its policy in rate regulation, of deducting only actual accrued depreciation irrespective of the past provisions made by the company (R. I, 39-40). On this view, since accrued depreciation is the criterion, business and accounting practice in making provision for the cost of operation represented by the consumption of service life is immaterial.

allowance was determined by the same methods used to ascertain the accrued depletion and depreciation actually existing in the properties: depreciation expense was computed by the straight-line method; depletion expense was computed by the unit-of-production method, thus varying with the actual amount of gas produced. The annual rates thus obtained for depreciation and depletion were then applied to the actual legitimate cost of the property (the investment) to give the annual allowance for depreciation and depletion. As the Commission stated, it was necessary to use the same method and base for computing the accrued depreciation and depletion, and for computing the future annual allowance therefor, because the annual allowance measures the economic-service-life of the utility's property consumed in one year, whereas accrued depreciation, being the sum of the depreciation allowances made in the past, measures on a given date the expiration of the service-life of the property. Consequently, the annual depreciation and depletion allowance must be correlated with the accrued depreciation and depletion in order to avoid injustice both to the utility and to the rate payer. (R. I, 37, 52.)

Relying on *United Railways v. West*, 280 U. S. 234, 253-254, the court below condemned the Commission's action in computing the annual allowance upon the basis of actual legitimate cost, and held that the allowance should have been based

upon the "present fair value" of Hope's physical property (R. IV; 192-198). This holding is indefensible, we submit, whether or not we are right in our view that the rule of *Smyth v. Ames* is no longer law.

If the doctrine of *Smyth v. Ames* is no longer controlling, as we have argued above (pp. 49-70), there can be no possible doubt as to the validity of the Commission's use of a prudent investment base to determine accrued depreciation and annual depreciation allowance, just as it may be used for the computation of a fair return. However, we submit that under the decisions of this Court, the Commission's action in this respect is proper even if the rule of *Smyth v. Ames* is still applicable to the rate base.

In *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, this Court approved the Commission's use of the actual cost, rather than the reproduction cost, of the utility's property as the base to be amortized by annual allowances in operating expenses. This Court agreed with the Commission, that "to make an allowance of amortization in excess of cost * * * would not be the computation of a proper expense but instead the allowance of additional profit over and above a fair return. Manifestly such an additional return would unjustly penalize consumers" (315 U. S. at 593).

The majority below sought to distinguish the *Pipeline* case in this connection on the ground that Hope is not a "wasting-asset business of limited life," as was the utility considered in the *Pipeline* case, but is rather "an ordinary public utility which is required by law to continue its service to the public" (R. IV, 195). This purported distinction, besides being insubstantial, ignores the controlling principles recognized by this Court in the *Pipeline* case.

Although, unlike the *Pipeline* case, there is no stipulation in the instant case as to the time when Hope will be forced out of business for lack of reserves, it would be the first to concede that its present available natural gas reserves are not unlimited. The record establishes that the Company is contemplating an extension of its pipeline to new sources of supply, in order to meet its requirements (R. I, 47; R. III, 149). If Hope does not build such a pipeline extension, sooner or later, but inevitably, it must be forced out of business for lack of reserves. For it is common knowledge that as natural gas is consumed, reserves are depleted and the ultimate exhaustion of the supply is inevitable. This was equally true of the company involved in the *Pipeline* case, which expected to terminate business in 1954 for lack of reserves but will unquestionably be able to continue in business after 1954 if it obtains additional reserves. The company in the *Pipeline*

case was not a sport within the class of extractive industries; it was a "wasting asset business of limited life" solely because it was engaged in producing natural gas. All such companies are in the same position, and if an amortization allowance may be grounded upon cost for the natural gas company involved in the *Pipeline* case it is equally permissible for Hope. Certainly, the mere absence of an accord as to the precise year in which Hope's reserves will be exhausted, present in the *Pipeline* case, should not endow Hope with a constitutional right to have its depreciation allowance computed on a reproduction cost basis—a basis which will compel ratepayers to return more than the amount invested.

But the propriety of an annual depreciation allowance based on cost does not depend upon the nature of the utility's business. In *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, involving a telephone company, which is clearly not a "wasting asset business of limited life," this Court approved an annual depreciation allowance based on cost, pointing out that where the annual depreciation allowance is excessive, "to that extent subscribers for the telephone service are required to provide, in effect, capital contributions, not to make good losses incurred by the utility in the service rendered and thus to keep its investment unimpaired, but to secure additional plant and equipment upon which the utility expects a

return" (*supra* at 169).⁴⁸ See also *United States v. Ludey*, 274 U. S. 295, 300-302. Indeed, by recognizing cost as a permissible basis of computing the depreciation allowance, the *Lindheimer* case modifies the contrary holding in the earlier *West* case, 280 U. S. 234, on which the instant court below relied. See Mr. Justice Butler, concurring in *Lindheimer v. Illinois Bell Telephone Co.*, 292 U. S. 151, 176; *Alexandria Water Company v. City Council of Alexandria*, 163 Va. 512. This is the view uniformly accepted by regulatory bodies, for despite the *West* case, the federal and state utility commissions, almost without exception, have continued to follow cost accounting for depreciation.⁴⁹

⁴⁸ Even if it is assumed that the purpose of annual depreciation allowances is to replace in the future the property which is currently being consumed, the fluctuation in price level would destroy any predictable relation between present value and future replacement cost. "To use as a measure of the year's consumption of plant a depreciation charge based on fluctuating present values substitutes conjecture for experience. Such a system would require the consumer of today to pay for an assumed operating expense which has never been incurred and which may never arise." *United Railways v. West*, 280 U. S. 234, 278 (Brandeis, J., dissenting). See also *Excess Income of St. Louis & O'Fallon Ry. Co.*, 124 I. C. C. 3, 29, 41. The price level at the time of replacement being unpredictable, present replacement cost is certainly no more reliable a basis for annual depreciation allowance than original cost. *United Railways v. West*, *supra*, at 290 (Stone, J., dissenting).

⁴⁹ *Depreciation Charges of Telephone and Steam Railroad Companies*, 177 I. C. C. 351, 374; *Re Interstate Power Co.*, (F. P. C.) 32 P. U. R. (N. S.) 1; *Re Chicago District Electric Generating Corp.*, (F. P. C.) 39 P. U. R. (N. S.) 263;

Regardless of the nature of Hope's business, since the annual allowance provided by the Commission is based upon a reasonable determination of the life of Hope's existing investment and will reimburse Hope to the amount of that investment, the constitutional requirements are met. Hope's investment is continually being consumed in service and under the Commission's method the Company is reimbursed for the cost concurrently with the consumption. The funds supplied by the customers in the form of rates to cover annual depreciation and depletion are immediately available to Hope for investment in additions and replacements, enabling Hope to earn without delay an annual return and annual depreciation allow-

Re Canadian River Gas Co., (F. P. C.) 43 P. U. R. (N. S.) 205; *Detroit v. Panhandle Eastern Pipe Line Co.*, (F. P. C.) 45 P. U. R. (N. S.) 203; *Re Alabama Water Service Co.*, (Ala.) 32 P. U. R. (N. S.) 129, 130; *Re Patrons of Lakeville Water Co.*, (Conn.) P. U. R. 1932D, 138, 143; *Re Peoples Gas Light & Coke Co.*, (Ill.) 19 P. U. R. (N. S.) 177, 257; *Re Lincoln Tel. & Tel. Co.*, (Neb.) 6 P. U. R. (N. S.) 81, 90; *Re Central Light & Power Co.*, (N. D.) 37 P. U. R. (N. S.) 106, 112; *Re North Dakota Power & Light Co.* (N. D.) 31 P. U. R. (N. S.) 26, 29; *Re Northern Power & Light Co.* (N. D.) 30 P. U. R. (N. S.) 1, 5; *Re Northern States Power Co.* (N. D.) 22 P. U. R. (N. S.) 364, 370; *Re Otter Tail Power Co.* (N. D.) 33 P. U. R. (N. S.) 301, 307; *Re Long Branch Sewer Co.* (N. J.) P. U. R. 1931A, 467, 473; *Re Yonkers Railroad Co.* (N. Y.) P. U. R. 1933B, 61, 84; *Re Yonkers Railroad Co.* (N. Y.) 9 P. U. R. (N. S.) 337, 365; *Re Swan Creek Electric Co.* (Utah) 35 P. U. R. (N. S.) 315, 316; *Re Mondovi Tel. Co.* (Wis.) P. U. R. 1933B, 319, 330; *Re Mondovi Tel. Co.* (Wis.) P. U. R. 1933D, 142; *Re Wisconsin Tel. Co.* (Wis.) 13 P. U. R. (N. S.) 224, 251.

ance upon that new property. The utility is therefore made whole and the integrity of its investment maintained.⁵⁰ Obviously, the Company ceases to have a right to a return upon the portion of the investment which has been consumed, and which is recouped from the rate payers through revenues covering annual depreciation allowances. See *Depreciation Charges of Telephone and Steam Railroad Companies*, 118 I. C. C. 295, 355; 177 I. C. C. 351, 410; Barnes, *The Economics of Public Utility Regulation* (1942), 261.

Accepted practice sanctions the Commission's choice of original cost as a basis for computing the depreciation allowance. To base the depreciation charge on cost is "the rule sanctioned by the universal practice of businessmen and governmental departments." (See Brandeis, J., dissenting in *United Railways v. West*, 280 U. S. 234, 275, citing an impressive array of authority drawn from all relevant data.) The practice of basing the depreciation charge on cost has been adopted and is being followed not only by non-

⁵⁰ No injustice to the Company would result from the fact that when property is retired, the cost of the replacing property may exceed the original cost of the retired property. For the new capital invested would be included in the rate base, and the Company entitled to a return thereon. Moreover, under the cost basis of depreciation, the depreciation allowance for the replacing property would be computed on its cost, and not on the cost of the retired property. Cf. *United Railways v. West*, 280 U. S. 234, 279 (Brandeis, J., dissenting).

utility enterprises,⁵¹ but also in all the systems of accounts established by governmental rate-making agencies, federal and state.⁵² The use of original cost in determining the depreciation charge is justified, as Mr. Justice Brandeis has demonstrated, by every relevant consideration of prudent business and accounting practice.

The universal business practice of basing depreciation on cost has significance for reasons other than the weight to be accorded to commercial custom. We are dealing here with the constitutional guarantee of due process; in its application to the present case, that guarantee, as we show above in discussing the underlying principle of *Smyth v.*

⁵¹ Gilman, *Accounting Concepts of Profit*, 348-349, 493; Sanders, Hatfield, and Moore, *A Statement of Accounting Principles* (1938), 31-32, 58-59, 60-65; Saliers, *Depreciation Principles and Applications*, 63, 68-69, 110; Montgomery, *Auditing Theory and Practice* (6th ed. 1940), 480; Paton and Littleton, *An Introduction to Corporate Accounting Standards*, 66, 89; see also Peloubet, *Special Problems in Accounting for Capital Assets*, 61 *Journal of Accountancy* 185; May, *The Influence of Accounting on the Development of an Economy*, 61 *Journal of Accountancy* 15-16; Bell and Jones, *Auditing* (1941), 245. Economists and accountants have likewise insisted that cost is the only proper basis of utility depreciation accounting. Mosher and Crawford, *Public Utility Regulation* (1933), 160-162; Jones and Biggam, *Principles of Public Utilities* (1937 ed.), 491 et seq.; Wilson, Herring and Eutsler, *Public Utility Regulation* (1938), 196 et seq.; see also Haun, *Inconsistencies in Public Utility Depreciation*, 38 *Mich. L. Rev.* 160, 479.

⁵² The systems of account referred to in n. 40, p. 91, *supra*, all adopt cost as the basis of depreciation.

Ames, means simply that there will be no arbitrary governmental interference with property rights. To limit a utility to a depreciation charge which is the same as that universally made by all business men, even though they are completely free of regulation, cannot in any realistic sense be characterized as arbitrary governmental action. To the contrary, the Commission would be guilty of arbitrary conduct if it blinded itself to the practical experience of business men and thereby saddled upon consumers a charge having no basis in business realities.⁵³

In the light of these considerations, we submit that even under the rule of *Smyth v. Ames*, rates which provide for a full return of the original investment satisfy all constitutional requirements in this respect.

⁵³ The court below held that the Commission should have made an annual allowance for depreciation and depletion on capital added to the rate base after 1940 (R. IV: 196). But the Commission was under no legal obligation to make any allowance whatever for future capital additions. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 592. Hence in allowing almost \$1,400,000 for net future capital additions for the years 1941-43 (R. I, 50), the Commission was conferring a benefit to which Hope was not entitled as a matter of law. It can hardly demand the additional boon of a depreciation allowance on this gratuity. Moreover, the amount properly to be allowed for depreciation will depend on future operations, which cannot easily be forecast.

VI

HOPE WAS NOT HARMED BY THE EXCLUSION FROM
1940 OPERATING EXPENSES OF \$165,963 FOR AN EX-
PERIMENTAL DEEP-TEST WELL

In accordance with the conservative practice of natural-gas companies, Hope had followed the practice of charging all exploration and development costs to operating expenses. The Commission approved of this practice and found that Hope's exploration and development costs for 1940 were \$407,920, but excluded from such costs the sum of \$165,963 for an experimental deep-test well which was completed dry in 1941 and charged by Hope on its books as an operating expense for 1941. The court below upheld Hope's contention that this sum should have been included in 1940 operating expenses. However, the court observed that "the matter can have little bearing in future hearings, as the test period will doubtless cover 1941 as well as 1940 and it will be immaterial which year carries the charge" (R. IV, 198).

Without discussing the propriety of excluding these costs from operating expenses for 1940, it is clear that Hope has not been harmed. The Commission delved into the details of Hope's transactions for 1940 solely to provide a basis for estimating its future expenses. Although the Commission found Hope's exploration and development costs to be \$407,920 for 1940, it allowed \$600,000 as the proper and reasonable annual

future allowance for exploration and development expenses, which represented a substantial increase in the expenses experienced by the Company in 1940. Since the amount found by the Commission (\$407,920) plus the additional amount claimed by Hope (\$165,963) is roughly \$25,000 less than the \$600,000 allowed by the Commission as the annual future allowance for such purposes, Hope cannot validly claim to have been harmed by this exclusion from its exploration and development costs for 1940.

VII

THE COMMISSION'S FINDINGS AS TO THE LAWFULNESS OF PAST RATES WERE PROPER AND, IF REVIEWABLE, SHOULD BE UPHOLD

As early as July 1938 the Cities of Cleveland and Akron had filed complaints with the Commission, charging that the rates collected by Hope from the East Ohio Gas Company were excessive and unreasonable (R. II, 1, 7). Cleveland prayed specially for a determination by the Commission that Hope's collected rates from East Ohio were unreasonable and therefore unlawful, and for a determination of the just and reasonable rates from June 30, 1939, to the date of the Commission's decision. Such determinations were requested "in the aid of State regulation" and to afford the Public Utilities Commission of Ohio a proper basis for disposition of a fund collected by East Ohio under bond from

Cleveland consumers since June 30, 1939 (R. II, 14).⁵⁴

The Commission, when it entered its order on May 26, 1942, reducing the rates to be charged by Hope after July 1, 1942, also made "Findings As To The Lawfulness Of Past Rates" (R. I, 8-13). It found that the rates charged by Hope during the period from June 30, 1939, to the effective date of the order were unjust and unreasonable and therefore "unlawful," and that the charges to East Ohio were excessive in the amount of \$830,892 in 1939, \$3,219,551 during 1940 and \$2,815,789 on an annual basis since 1940 (R. I, 12-13). These findings were made as "an aid to state regulation" pursuant to the complaints of the Cities of Cleveland and Akron (R. I, 67-69; R. II, 1-2, 7-8, 14-15).

The court below set aside the Commission's findings as to past rates, holding that rates filed with the Commission pursuant to Section 4 (c) of the Act "become the only lawful rates which the utility could charge or accept" until changed by a Commission order prescribing rates for the future, and that the Commission could make findings with respect to past rates only as a step in the process of fixing rates for the future, and not "as an aid

⁵⁴ This fund represents the difference between East Ohio's previous rates and the lower rates established by ordinance of the City of Cleveland, which East Ohio is collecting pending its appeal from the ordinance to the Public Utilities Commission of Ohio.

to state regulation" (R. IV, 199-203). The court also held that if viewed as an incident of the Commission's power to fix future rates, the findings as to past rates were invalid for the same reasons as the future rate order and for the further reason that the Commission based these findings on experience for the years in question rather than on estimates taken from the experience of a prior period (R. IV, 200, 202).

We submit that this action was error since the findings were within the statutory power of the Commission and were proper for the reasons advanced above to sustain the order prescribing future rates. While we have serious doubts as to whether the findings as to past rates present a matter for judicial review, we believe that if they are reviewable, their propriety should be sustained in this Court.

A. THE COMMISSION'S "FINDINGS AS TO THE LAWFULNESS OF PAST RATES" MAY NOT BE REVIEWABLE HERE

Section 19 (b) of the Natural Gas Act vests in the courts of appeals jurisdiction to review any "order" of the Commission upon the petition of a party "aggrieved" by the order. In the exercise of this jurisdiction, courts reviewing a rate order of the Commission would necessarily have the right to review all findings made by the Commission in connection therewith, including findings as to the reasonableness of past rates made in the course of issuing such rate order.

However, it is doubtful whether there may be judicial review of findings as to past rates, when made independently of a rate order, for example as an aid to state regulation, which was here the case. The fact that these findings are not designated as an order is of course immaterial to the question of reviewability for "it is the substance of what the Commission has purported to do and has done which is decisive. *Powell v. United States*, 300 U. S. 276, 284-285; *A. F. of L. v. Labor Board*, 308 U. S. 401, 408." *Columbia Broadcasting System v. United States*, 316 U. S. 407, 416.

But considering the substance and the legal effect of the findings, we entertain substantial doubts whether the findings standing alone have the legal impact upon Hope which this Court has hitherto deemed necessary for judicial review. The findings declare that rates charged by Hope since June 30, 1939, are unlawful, but they do not require or inhibit any action by Hope as a result thereof. It is not contended that the Commission has threatened to impose any legal sanctions as a result of the findings, or has attempted to enforce them in any way, or that as a result of these findings any of Hope's customers have refused to deal with the Company (cf. *Columbia Broadcasting System v. United States*, *supra*); and there is no evidence of any other substantial adverse effect therefrom.

It is true that the findings in question were made "as an aid to state regulation," and may furnish the basis for an order by a state regulatory body or court for repayment of excessive rates. At present, however, these findings are merely a preliminary to possible future action in proceedings brought before totally independent governmental bodies, proceedings whose outcome may hinge upon many factors unrelated to the Commission's findings and whose result might conceivably leave Hope unharmed. For these reasons, we incline to the view that the findings do not have such effect upon Hope's legal rights nor such legal or substantial impact upon Hope's interests to make them reviewable under the principles enunciated by this Court. *Rochester Tel. Corp. v. United States*, 307 U. S. 125, 130; *United States v. Los Angeles & S. L. R. Co.*, 273 U. S. 299, 309, 310.

We do not mean to imply that the state commission is at liberty to ignore the findings. They are plainly admissible in the state proceedings (see *United States v. Los Angeles & S. L. R.*, 273 U. S. 299, 312), and their effect is strengthened by the fact of affiliation between respondent and the local distributing companies. Cf. *Houston v. Southwestern Tel. Co.*, 259 U. S. 318, 323. We recognize, moreover, the practical advantage of permitting judicial review in proceedings to which the Federal Power Commission is a party. The Commission has no desire to avoid review, and

for that reason did not press below the non-reviewability of the findings. But since the question goes to the statutory authority of the court below, we feel obliged to raise the issue.

**B. THE COMMISSION HAS AUTHORITY TO MAKE FINDINGS AS TO
LAWFULNESS OF PAST RATES "AS AN AID TO STATE REGULATION"**

The authority granted to the Commission in the Natural Gas Act to fix rates "to be thereafter observed and in force" (Sec. 5 (a)) admittedly does not include authority to *fix* past rates. But there is clearly power under the Act to determine and make findings as to the *lawfulness* of past rates. Section 14 (a) empowers the Commission to investigate any matter in order to determine whether any person *has* violated any provision of the Act, and Section 4 (a) explicitly forbids and declares unlawful the charging of unjust and unreasonable rates. Since the charging of such rates is an unlawful act and in violation of Section 4 (a), an investigation of the lawfulness of Hope's past rates is clearly within the ambit of the investigatory power granted the Commission by Section 14 (a).⁵⁵ Moreover, the Commission may, upon its own motion or at the request of a state commission, investigate and determine the

⁵⁵ The Interstate Commerce Commission has made similar determinations under an analogous provision of the Motor Carrier Act of 1935 (Secs. 216, 217). See *W. A. Barrows Porcelain Enamel Co. v. Cushman Motor Delivery Co.*, 11 M. C. C. 365, 366; *Dirie Mercerizing Co. v. E.T. & W.N.C. Motor Transportation Co.*, 21 M. C. C. 491, 492.

cost of production or transportation of natural gas in cases where it may not establish rates (Section 5 (b)), and is required by Section 17 (c) to "make available to the several State commissions such information and reports as may be of assistance in State regulation of natural gas companies." The findings as to past rates fall within the contemplation of these provisions, constituting not only determinations as to cost but also "information and reports" as to lawful and reasonable rates for the period in question, as an aid to State regulation.

The court below discerned jurisdictional objections to the findings because rates filed by companies with the Commission pursuant to Section 4 (c) of the Act become the "lawful" rates until changed by Commission order, and such rates, it thought, may not be found to be "unlawful" (R. IV, 200, 202). The court's error, we suggest, consists in overlooking the clearly established distinction between "legal" and "lawful" rates. Companies subject to the Act must "file with the Commission" and "keep open * * * for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission" (Section 4 (c)). These are the "legal" rates which must be charged to all consumers. Cf. *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 284

U. S. 370, 384; *Louisville & N. R. Co. v. Maxwell*, 237 U. S. 94. But in addition to the requirement as to filing of rates, the Act imposes a duty on all companies subject to the jurisdiction of the Commission to charge only "just and reasonable" rates, and declares unlawful "any such rate or charge that is not just and reasonable" (Section 11 (a)). The distinction is plain: the filed rates are the "legal" rates, but only just and reasonable rates are the "lawful" rates. "In other words, the legal rate was not made by the statute a lawful rate—it was lawful only if it was reasonable." *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 284 U. S. 370, 384; see *Re Home Gas Co.*, 39 P. U. R. (N. S.) 102, 109.

The holding below, that rates filed under Section 4 (c) become the only "lawful" ones, would deprive Section 4 (a) of all meaning. For if rates once filed become "lawful" under Section 4 (a), no matter how unjust or unreasonable they may be, and if the Commission is powerless to consider and determine whether they meet the standards of justness and reasonableness imposed by Section 4 (a), the statutory declaration of their "unlawfulness" becomes an empty phrase, and the rate payers may be left without a forum in which to challenge the lawfulness of interstate wholesale gas rates prevailing between the date of the Act's

passage and the effective date of a Commission rate-fixing order.

Even in the absence of the Natural Gas Act, state regulatory commissions would appear to be without power to regulate interstate wholesale rates for natural gas. *Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, 317 U. S. 456, 468; *Illinois Natural Gas Co. v. Central Illinois Public Service Co.*, 314 U. S. 498, 506; *Missouri v. Kansas Natural Gas Co.*, 265 U. S. 298; *Public Utilities Commission v. Attleboro Steam & Electric Co.*, 273 U. S. 83. It is clear, at all events that after the effective date of the Act, the state regulatory commissions do not have power to determine the lawfulness of Hope's interstate wholesale rates since "Congress by that Act . . . pre-empted the regulatory power over transportation and sale of natural gas in interstate commerce." *Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, *supra* at 466; cf. *Illinois Natural Gas Co. v. Central Illinois Public Service Co.*, *supra*. While a state commission may call for data in Hope's possession to aid in determining the lawfulness of a distributor's local rates (*Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, *supra*, at 468, 470), this power falls short of a full-scale investigation necessary to determine the reasonableness of Hope's interstate rates.

The courts, whether state or federal, are also without power to determine the lawfulness of

interstate wholesale rates for natural gas, and, in order to maintain a uniform standard of rates, must refer proceedings involving the reasonableness of such rates to the regulatory commission concerned, for primary consideration. Cf. *Texas & Pacific Ry. Co. v. Abilene Cotton Oil Co.*, 204 U. S. 426; *Board of R. R. Comm'rs v. Great Northern Ry. Co.*, 281 U. S. 412, 422; *U. S. Navigation Co. v. Cunard S. S. Co.*, 284 U. S. 474. The determination of a question such as whether past rates were "just and reasonable" and hence "lawful" involves intricate and technical matters of fact requiring "comprehensive study of an expert body continuously engaged in administrative supervision." *Board of R. R. Comm'rs v. Great Northern Ry. Co.*, *supra*, at 422; *Great Northern Ry. Co. v. Merchants Elevator Co.*, 259 U. S. 285, 291. Jurisdiction in the courts or in a state regulatory body over these issues would pave the way for inconsistent adjudications by a variety of tribunals—the very "confusion of functions" which the Act was designed to avoid (*Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, *supra*, at 467), and which this Court long ago condemned in the *Abilene* case, *supra*, at 440.

On the other hand, recognition of the Commission's jurisdiction to determine the lawfulness of interstate wholesale rates charged since the effective date of the Act will effectuate the Congress-

sional objective of "a harmonious, dual system of regulation of the natural gas industry—federal and state regulatory bodies operating side by side, each active in its own sphere. See H. Rep. No. 2651, 74th Cong., 2d Sess., pp. 1-3; H. Rep. No. 709, 75th Cong., 1st Sess., pp. 1-4; Sen. Rep. No. 1162, 75th Cong., 1st Sess." *Public Utilities Comm. of Ohio v. United Fuel Gas Co.*, *supra*, at 467.

The lower court's rationale that because the Commission lacks authority to award reparations it may not inquire into the lawfulness of past rates (R. IV, 200-202) conflicts sharply with the decisions of this Court. Thus, the lack of power in the Interstate Commerce Commission to grant reparations for intrastate rates charged and collected which discriminated unduly against interstate commerce does not deprive it of power "to inquire whether injustice had been done and to make report accordingly" to the District Court where a shipper's suit for restitution was pending. *Atlantic Coast Line Co. v. Florida*, 295 U. S. 301, at 312. And in *United States v. Morgan*, 307 U. S. 183, proceedings for the distribution of the fund collected under an invalid order of the Secretary of Agriculture were restrained pending a determination by the Secretary of the just and reasonable rates during the period covered by the fund. This Court pointed out that the lack of authority in the

Secretary to award reparation in that proceeding did not affect his power to investigate and decide the reasonableness of past rates. *United States v. Morgan, supra*, at 192.

While we believe the conclusion would be the same if the findings in question were made by the Commission on its own motion, they take on additional significance from the fact that the Cities of Cleveland and Akron had expressly requested an investigation as to the lawfulness of these past rates, to afford the Public Utilities Commission of Ohio a basis for determining reasonable rates charged by East Ohio to its intrastate customers. Cf. *United States v. Morgan, supra*, at 193.

For these reasons, we submit that the findings as to past rates were well within the Commission's statutory powers.

C. THE COMMISSION'S FINDINGS THAT PAST RATES WERE UNREASONABLE ARE SUPPORTED BY SUBSTANTIAL EVIDENCE AND ARE OTHERWISE PROPER

No extended argument is warranted to demonstrate the propriety of the findings on past rates, considered as a rate-making determination. The Commission adopted the same principles for its "Findings as to Lawfulness of Past Rates" as it did in fixing rates for the future, and the constitutional and statutory validity of those principles has already been discussed. To the extent that the court below condemned the findings for the

reasons which led it to overturn the Commission's order prescribing rates, we suggest that the court's action was erroneous for the reasons already stated.

The court below, however, also advanced the objection that the Commission, in formulating its findings as to past rates, had used actual experience as to Hope's expenses rather than reasonable estimates of expenses based on prior experience (R. IV, 200, 202): We believe that this ruling was erroneous.

In making its findings as to past rates, the Commission employed Hope's actual experience as to expenses and sales for 1939 and for each of the subsequent years. While a forecast may be requisite when the reasonable operation of future rates is in question, it is impossible to conceive of a sounder test for determining whether rates were more reasonable and lawful in the past than the actual operating experience of the Company during the years in question. Indeed, as this Court has held, it would have been arbitrary for the Commission to prefer prophecy to a survey when the actual facts were available. *West Ohio Gas Co. v. Public Utilities Commission*, 294 U. S. 63, 79, 82. The lower court's observation that it is "impractical to conduct a wholesale natural-gas business on the basis of annual changes in rates" (R. IV, 203) overlooks the fact that many whole-

sale contracts for utility service provide for the annual adjustment of rates. As a rule, a utility has only a few wholesale customers, and when the major customers, like Hope's, are its affiliates the periodic change in rates is facilitated. Following the practice of the utilities in each case, provision has been made by regulatory bodies for periodic changes in wholesale rates. *Re Chicago District Electric Generating Corp.*, 39 P. U. R. (N. S.) 263, 281; *Re Safe Harbor Water Power Corp.*, 34 P. U. R. (N. S.) 236, 247.

In finding the lawful rates for 1939, 1940, 1941, and up to the date of the Commission's order fixing rates for the future, the Commission determined the investment base for each period, and allowed a 6½% rate of return thereon, in addition to all operating expenses plus the amount of tax required under lawful rates (R. I, 11-13). It was only the excess over this liberal allowance which the Commission found to be the result of excessive and unreasonable charges, a method which can hardly be deemed unreasonable or arbitrary.

There is substantial evidence to support each basic and ultimate finding made by the Commission as to the lawfulness of past rates (R. I, 225-341, 373-390; R. III, 25-81, 173-201, 224-365, 373-394, 397-489), and we submit that the findings are entitled to the finality provided for by Section 19 (b) of the Act.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment below should be reversed.

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APPENDIX A

The pertinent provisions of the Natural Gas Act of 1938, c. 556, 52 Stat. 821 (15 U. S. C. § 717) are as follows:

SECTION 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

(b) The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

SEC. 2. When used in this Act, unless the context otherwise requires—

(1) "Person" includes an individual or a corporation.

(2) "Corporation" includes any corporation, joint-stock company, partnership, association, business trust, organized group of

persons, whether incorporated or not, receiver or receivers, trustee or trustees of any of the foregoing, but shall not include municipalities as hereinafter defined.

(3) "Municipality" means a city, county, or other political subdivision or agency of a State.

(4) "State" means a State admitted to the Union, the District of Columbia, and any organized Territory of the United States.

(5) "Natural gas" means either natural gas unmixed, or any mixture of natural and artificial gas.

(6) "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

(7) "Interstate commerce" means commerce between any point in a State and any point outside thereof, or between points within the same State but through any place outside thereof, but only insofar as such commerce takes place within the United States.

(8) "State commission" means the regulatory body of the State or municipality having jurisdiction to regulate rates and charges for the sale of natural gas to consumers within the State or municipality.

(9) "Commission" and "Commissioner" means the Federal Power Commission, and a member thereof, respectively.

* * * * *

RATES AND CHARGES; SCHEDULES; SUSPENSION OF NEW RATES

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the

transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this Act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

* * * *

FIXING RATES AND CHARGES; DETERMINATION OF COST OF PRODUCTION OR TRANSPORTATION

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality,

State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas.

ASCERTAINMENT OF COST OF PROPERTY

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost

of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

* * * * *

ACCOUNTS, RECORDS, AND MEMORANDA

SEC. 8. (a) Every natural-gas company shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this Act: *Provided, however,* That nothing in this Act shall relieve any such natural gas company from keeping any accounts, memoranda, or records which such natural-gas company may be required to keep by or under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by such natural-gas companies, and may classify such natural-gas companies and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may determine by order the accounts in which particular outlays or receipts shall be entered, charged, or credited. The burden of proof to justify every accounting entry

questioned by the Commission shall be on the person making, authorizing, or requiring such entry, and the Commission may suspend a charge or credit pending submission of satisfactory proof in support thereof.

* * * * *

RATES OF DEPRECIATION

SEC. 9. (a) The Commission may, after hearing, require natural-gas companies to carry proper and adequate depreciation and amortization accounts in accordance with such rules, regulations, and forms of account as the Commission may prescribe. The Commission may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas. Each natural-gas company shall conform its depreciation and amortization accounts to the rates so ascertained, determined, and fixed. No natural-gas company subject to the jurisdiction of the Commission shall charge to operating expenses any depreciation or amortization charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation or amortization other than that prescribed therefor by the Commission. No such natural-gas company shall in any case include in any form under its operating or other expenses any depreciation, amortization, or other charge or expenditure included elsewhere as a depreciation or amortization charge or otherwise under its operating or

other expenses. Nothing in this section shall limit the power of a State commission to determine in the exercise of its jurisdiction, with respect to any natural-gas company, the percentage rates of depreciation or amortization to be allowed, as to any class of property of such natural-gas company, or the composite depreciation or amortization rate, for the purpose of determining rates or charges.

* * * * *

COMPLAINTS

SEC. 13. Any State, municipality, or State commission complaining of anything done or omitted to be done by any natural-gas company in contravention of the provisions of this Act may apply to the Commission by petition, which shall briefly state the facts, whereupon a statement of the complaint thus made shall be forwarded by the Commission to such natural-gas company, which shall be called upon to satisfy the complaint or to answer the same in writing within a reasonable time to be specified by the Commission.

INVESTIGATIONS BY COMMISSION; ATTENDANCE OF WITNESSES; DEPOSITIONS

SEC. 14. (a) The Commission may investigate any facts, conditions, practices, or matters which it may find necessary or proper in order to determine whether any person has violated or is about to violate any provision of this Act or any rule, regulation, or order thereunder, or to aid in the enforcement of the provisions of this Act or in prescribing rules or regulations thereunder, or in obtaining information to serve as a basis for

recommending further legislation to the Congress. The Commission may permit any person to file with it a statement in writing, under oath or otherwise, as it shall determine, as to any or all facts and circumstances concerning a matter which may be the subject of investigation. The Commission, in its discretion, may publish in the manner authorized by section 312 of the Federal Power Act, and make available to State commissions and municipalities, information concerning any such matter.

* * * * *

ADMINISTRATIVE POWERS OF COMMISSION; RULES, REGULATIONS, AND ORDERS

SEC. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this Act. Among other things; such rules and regulations may define accounting, technical, and trade terms used in this Act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different require-

ments for different classes of persons or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours.

USE OF JOINT BOARDS; COOPERATION WITH STATE COMMISSIONS

SEC. 17. (a) The Commission may refer any matter arising in the administration of this Act to a board to be composed of a member or members, as determined by the Commission, from the State or each of the States affected or to be affected by such matter. Any such board shall be vested with the same power and be subject to the same duties and liabilities as in the case of a member of the Commission when designated by the Commission to hold any hearings. The action of such board shall have such force and effect and its proceedings shall be conducted in such manner as the Commission shall by regulations prescribe. The Board shall be appointed by the Commission from persons nominated by the State commission of each State affected, or by the Governor of such State if there is no State commission. Each State affected shall be entitled to the same number of representatives on the board unless the nominating power of such State waives such right. The Commission shall have discretion to reject the nominee from any State, but shall thereupon invite a new nomination from that State. The members of a board shall receive such allowances for expenses as the Commission shall provide. The Commission may, when in its discretion sufficient

reason exists therefor, revoke any reference to such a board.

(b) The Commission may confer with any State commission regarding rate structures, costs, accounts, charges, practices, classifications, and regulations of natural-gas companies; and the Commission is authorized, under such rules and regulations as it shall prescribe, to hold joint hearings with any State commission in connection with any matter with respect to which the Commission is authorized to act. The Commission is authorized in the administration of this Act to avail itself of such cooperation, services, records, and facilities as may be afforded by any State commission.

(c) The Commission shall make available to the several State commissions such information and reports as may be of assistance in State regulation of natural-gas companies. Whenever the Commission can do so without prejudice to the efficient and proper conduct of its affairs, it may, upon request from a State commission, make available to such State commission as witnesses any of its trained rate, valuation, or other experts, subject to reimbursement of the compensation and traveling expenses of such witnesses. * * *

REHEARINGS; COURT REVIEW OF ORDERS

SEC. 19. (b) Any party to a proceeding under this Act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located

or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be served upon any member of the Commission and thereupon the Commission shall certify and file with the court a transcript of the record upon which the order complained of was entered. Upon the filing of such transcript such court shall have exclusive jurisdiction to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence; and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by sub-

stantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

APPENDIX B

HOPE NATURAL GAS COMPANY COMPARATIVE STATEMENTS, 1939-1942

TABLE 1.—*Hope Natural Gas Company, comparative statement of revenues and expenses, per books, years ended December 31, 1939-1942, inclusive*

	Gas revenue at old rates				1942 revenue at new rates for full year
	1939	1940 (Commis- sion test period)	1941	1942 ¹	
(1)	(2)	(3)	(4)	(5)	(6)
REVENUES					
Interstate sales					
The East Ohio Gas Co.	\$12,356,560	\$14,726,736	\$16,678,934	\$18,570,950	\$15,009,398
The Peoples Nat. Gas Co.	1,371,757	3,457,207	5,722,362	5,634,367	4,523,365
Fayette County Gas Co.	264,725	270,618	284,548	260,718	235,888
The River Gas Co.	83,174	156,063	119,595	133,036	133,036
Manufacturers Lt. & Ht. Co.	787,738	706,130	629,701	630,712	570,644
Total Interstate	14,866,894	19,296,755	22,835,340	25,229,783	20,472,331
Other revenues	3,472,972	5,099,663	5,296,788	3,988,036	
Total revenues—per books	18,339,866	24,396,418	28,132,128	29,217,819	
OPERATING EXPENSE					
Production expenses	1,439,971	1,651,802	1,790,100	2,322,256	
Gas purchased	7,746,854	8,629,481	10,432,993	10,696,307	
Transmission expenses	1,791,070	2,303,831	2,730,636	2,869,637	
Distribution expenses	201,925	218,760	240,684	269,399	
Cust. acctg. & coll. expenses	160,288	160,265	160,768	179,154	
Sales promotion	5,982	6,089	1,617	30	
Administrative & general	1,593,814	1,727,314	1,858,625	1,576,012	
Taxes (except Fed. income)	1,211,732	1,464,514	1,540,105	1,509,639	
Subtotal	14,151,549	16,162,116	18,755,528	19,392,404	
Depreciation & depletion	1,224,759	1,469,582	1,551,001	1,455,009	
Exploration and dev. costs	455,179	427,233	761,598	552,704	
Total except Fed. income tax	15,831,487	18,058,931	21,068,097	21,400,117	
Net operating income (before Fed. income tax)	2,508,369	6,337,487	7,064,031	7,817,702	
Federal income tax	225,000	1,000,000	1,750,000	2,020,000	
Net operating income	2,283,369	5,337,487	5,314,031	5,797,702	
Source	R 111, p. 293	R 111 p. 295	Annual report, p. 301	Annual report, p. 301	

¹ Reduced by refund of 3¢ per

MCF \$115,923 \$292,158 \$483,580

² Includes \$1,952,606 of revenues not received due to rate reduction effective July 15, 1942.

See computation on following schedule

TABLE 1-A.—*Hope Natural Gas Company, statement of M. c. f. of gas sold during 1942 showing (a) actual revenues for 1942 (6½ months at old rates and 5½ months at new rates), (b) revenues for 1942 computed at old rates for full year, (c) revenues for 1942 computed at new rates for full year*

(1)	M. C. F. (2)	Revenue 1942 (3)	1942 revenue computed at—		1942 revenue computed at—		Reduction in revenues based on full year 1942
			Average rate before F. P. C. order (4)	Amount (5)	Average rate after F. P. C. order (6)	Amount (7)	
INTERSTATE SALES							
The East Ohio Gas Company	50,879,314	\$17,143,714	Cents 35.5	\$18,570,950	Cents 29.5	\$15,000,396	\$3,561,552
The Peoples Natural Gas Company	15,871,455	5,143,106	35.5	5,634,367	28.5	4,523,365	1,111,002
Fayette County Gas Company	827,678	250,666	31.5	260,718	28.5	235,888	24,830
The River Gas Company	380,103	133,036	35.0	133,036	35.0	133,036	
Manufacturers Light & Heat Company	2,002,261	606,453	31.5	630,712	28.5	570,644	60,068
	60,960,811	23,277,172		25,229,783		20,472,331	4,757,452
INTRASTATE SALES							
Residential	4,618,987	1,726,740	No change		No change		
Commercial	708,477	295,350					
Industrial	6,341,049	1,584,144					
Pub. St. and Highway Ltg.	479	173					
Other sales to public authorities	676	225					
Other sales	445,694	124,419					
Intrastate sales to other gas utilities	231,091	37,980					
Total	12,346,544	3,739,031		3,739,031		3,739,031	
Total gas service revenues							
Other gas revenues		249,004		249,004		249,004	
Total operating revenues	82,307,355	27,265,242		29,217,818		24,460,366	

TABLE 2.—Hope Natural Gas Company, comparative statement of M. C. F. of gas sales, per books, years ended December 31, 1939–1942, inclusive

	1939	1940	1941	1942
INTERSTATE SALES—M. C. F.				
The East Ohio Gas Company	33,907,672	40,376,091	44,320,966	50,879,314
The Peoples Natural Gas Company	3,864,104	9,738,612	16,119,330	15,871,455
Fayette County Gas Company	840,398	859,106	903,962	827,678
The River Gas Company	237,646	388,750	341,699	380,103
Manufacturers Light & Heat Company	2,500,755	2,241,984	1,999,052	2,002,261
Total interstate sales—M. C. F.	41,350,569	53,604,243	63,685,009	69,960,811
Other sales—M. C. F.	10,011,312	15,451,527	16,251,484	12,346,544
Total sales—M. C. F.	51,361,881	69,055,770	79,936,493	82,307,355
Source	R. III, p. 257	R. III, p. 307	Annual re- port, p. 425	Annual re- port, p. 425

TABLE 3.—Hope Natural Gas Company, comparative statement of normal tax net income, per income tax returns

	1939	1940	1941	1942
Normal tax net income, per income tax return ¹	\$1,160,733	\$3,916,999	\$5,127,652	\$4,397,436
6½ months' rate reduction reflected in 1942 income				1,952,606
Comparative normal tax net income	1,160,733	3,916,999	5,127,652	6,350,042

¹ Federal income tax returns have not been closed since 1933.

TABLE 4.—Hope Natural Gas Company, comparative statement of gas plant and other assets—per books

	(R. III, p. 17) Dec. 31, 1939	(R. III, p. 17) Dec. 31, 1940	(Annual report, p. 200) Dec. 31, 1941	(Annual report, p. 200) Dec. 31, 1942
Total utility plant	\$64,250,655	\$65,193,287	\$66,698,621	\$67,392,628
Reserves for depl., depr., and amort	46,041,155	46,737,713	47,296,193	48,079,787
Net investment in plant	18,209,500	18,455,574	19,402,428	19,312,841
Net current assets (principally temporary cash investments)	14,678,387	17,377,408	16,780,619	18,805,973
Fund and miscellaneous accounts	334,903	295,489	2,504,547	3,568,166
Total net investment in assets, etc	33,222,790	36,128,471	38,687,594	41,687,080
Represented by:				
Common stock	27,969,300	27,969,309	27,969,300	27,969,300
Surplus	5,253,490	8,159,171	10,718,294	13,717,780
Invested capital—per books	33,222,790	36,128,471	38,687,594	41,687,080
Invested capital—per tax returns, as adjusted		31,658,887	33,821,749	36,562,811

TABLE 5.—Hope Natural Gas Company, indicated rate reduction based on findings of the Commission for the year 1939 and reported changes in plant, revenues, and expenses to December 31, 1942

	1939 per commission findings	Increase per books	1942
Operating revenues from interstate sales	\$14,866,894	\$10,362,889	\$25,229,783
Operating deductions:			
Operating expenses, except Federal income tax	11,805,933	5,053,556	16,859,489
Federal income tax	191,521	2,348,496	2,540,017
Total	11,997,454	7,402,052	19,399,506
Net operating revenues from interstate sales	2,869,440	2,960,837	5,830,277
Return at 6½%	2,101,216	219,516	2,320,732
Excess earnings before income tax saving	768,224	2,741,321	3,509,545
Income tax saving	151,805	2,187,892	2,339,697
Total indicated rate reduction	920,029	4,929,213	5,849,242
Normal tax net income, per book accruals, 1942		\$4,397,436	
Add: 5½ months rate reduction reflected in 1942 income		1,952,606	
Total		6,350,042	
Normal tax (24%) and surtax (16%)			\$2,540,017
Rate base—1939	\$32,326,398		
Net increase, per books	3,377,171		
Rate base—1942	35,703,569		
6½% return	2,320,732		
Net increase 1939-1942			
	Jan. 1, 1939	Increase	Dec. 31, 1942
Total utility plant, per books	\$56,649,799	\$10,742,859	\$67,392,658
Reserves for depl., depr. and amort.	40,714,019	7,365,688	48,079,707
Net investment per books	15,935,780	3,377,171	19,312,951

NOTE.—Includes former Reserve Gas Company property.

APPENDIX C

TABULATION OF STATE STATUTES CONCERNING THE ACCOUNTS AND THE ISSUANCE OF SECURITIES OF ELECTRIC OR GAS UTILITIES

AUTHORITY TO REGULATE ISSUANCE OF SECURITIES

The following State statutes authorize public service commissions to regulate the issuance of securities by electric or gas utilities:

<i>States</i>	<i>Statutory Reference</i>
Alabama	Secs. 9744-9753 Code of Ala., 1923.
Arizona	Sec. 708, Rev. Code of Ariz., 1928.
Arkansas	Act 324, Acts of Gen. Assembly of Ark., for 1935, Secs. 58 and 59.
California	L. 1915, Ch. 91, Sec. 52 (a).
Connecticut	Ch. 191, Public Acts of 1935.
District of Columbia	D. C. Code, T. 26, Sec. 99.
Georgia	Sec. 2065, 1926 Code.
Illinois	R. S. 1933, Ch. 111a, Sec. 35.
Indiana	Ch. 5, Pub. Serv. Acts, Secs. 51-503, 54-504.
Kansas	Sec. 60-125, Gen. Sts. of Kans., 1935.
Kentucky	Sec. 3-59-24, Ky. Stats.
Maine	Sec. 41, Ch. 62, Rev. Stats.
Maryland	Sec. 392, Art. 23, Ann. Code of P. G. L. of Md.
Massachusetts	Ch. 222, Mass. Acts of 1935.
Michigan	Sec. 11077, Compiled Laws of 1929.
Missouri	Secs. 5196-5198, Rev. St., 1929.
Nebraska	Secs. 75-1201, C. S., 1929.
New Hampshire	Ch. 24, Sec. 1, P. L. of N. H.
New Jersey	Sec. 167-24 (e) & (f), Supp.
New Mexico	Sec. 18, Chap. 84 (H. B. 29) Laws 1941.
New York	Sec. 69, Public Service Law.
North Carolina	C. S. 1142 (18); Sec. 18, Ch. 307 P. L. 1933.
North Dakota	Sec. 4609c 20; Supp. C. L. of N. D.
Ohio	Secs. 614-53-54-55, Gen. Code of Ohio.
Oregon	Ch. 441, Ore. L. 1933.
Pennsylvania	Art. VI, Secs. 601-604, L. 1937.
Rhode Island	Ch. 2345 P. L. of 1926.
South Carolina	1932 Reg. Act, Sec. 1 (i), Sec. 2 (m) & (s).
Tennessee	Sec. 5452 (d), Code of Tenn.
Vermont	Sec. 5953, P. L. Vt. Also Secs. 5991 & 6100.
Virginia	Ch. 160A, Secs. 4073 (1)-4073 (16).
Washington	Sec. 2, Ch. 540, L. 1933.
Wisconsin	Ch. 184, Wisc. Stats.

The following States have no such statute:

Colorado	Montana
Delaware ¹	Nevada
Florida ²	Oklahoma
Idaho	South Dakota ²
Iowa ³	Texas ²
Louisiana	Utah
Minnesota ²	West Virginia
Mississippi ²	Wyoming

AUTHORITY TO PRESCRIBE UNIFORM SYSTEM OF ACCOUNTS

The following State statutes authorize public service commissions to prescribe a uniform system of accounts for electric or gas utilities:

States	Statutory Reference	Date of First Order Adopting Uniform System of Accounts
Alabama	Secs. 9786-9788, Code of Ala.; 1923	February 6, 1924.
Arizona	Sec. 3, Const. Art. XV	1926.
Arkansas	Act 324, Acts of Gen. Assembly of Ark., 1925, Secs. 22 (a) & 8 (c)	January 1, 1943.
California	Sec. 48, Act 6386, G. L.	January 16, 1916.
Colorado	Sec. 33, p. 480, L. 1913.	November 1, 1923.
Connecticut	Sec. 3602, Gen. Sts. Rev. 1930	1930.
District of Columbia	Sec. 32-37, T. 26, D. C. Code	October 24, 1923.
Georgia	Sec. 2663, Code 1926	October 27, 1913.
Idaho	Sec. 59-524, -525, Id. Code Ann	1919.
Illinois	Secs. 11-15, Ch. 111 2/3, R. S. 1933.	
Indiana	Sec. 54-209, P. S. C. Acts.	May 1, 1913.
Kansas	Secs. 66-122, 123, R. S.	October 27, 1922.
Kentucky	Sec. 4 (i), p. 580, L. 1934.	1935.
Louisiana ¹	(See note)	
Maine	Secs. 17-21, Ch. 62, R. S.	July 1, 1915.
Maryland	Sec. 388, Art. 23, Ann. Code, P. G. L. of Md.	June 12, 1911.
Massachusetts	Ch. 382, Mass. Acts of 1887	1887.
Michigan	Sec. 11098, Ch. 209, C. L.	December 18, 1914.

¹ The Louisiana Commission advises that it has adopted the gas and electric systems of accounts prescribed by the National Association of Railroad and Utilities Commissioners which systems of accounts have been used by the Louisiana Commission for a number of years.

See "State Commission Jurisdiction and Regulation of Electric and Gas Utilities" (N.P.C., Jan. 1941).

States	Statutory Reference	Date of First Order Adopting Uniform System of Accounts
Missouri	Sec. 5190, Mo. Stats. Ann.	January 1, 1915.
Montana	Sec. 3885, Code of 1921	1913
Nebraska	Sec. 1, Const. Art. X	None adopted.
Nevada	Sec. 6109, C. L.	1923
New Hemisphere	Sec. 7, Ch. 240, Public Laws	1914
New Jersey	Sec. 167-17 (d), Supp.	December 3, 1912
New Mexico	Secs. 28 and 30 of P. U. Act, Chap. 84, Laws of 1941.	January 1, 1942
New York	Sec. 66, subd. 4, P. S. L.	October 21, 1908
North Carolina	C. S. 1112 (13); Sec. 13, Ch. 307, P. L. 1933	November 18, 1901
North Dakota	Ch. 192, L. 1919	July 29, 1921
Ohio	Sec. 614-10, Gen. Code	January 3, 1913
Oklahoma	Okla. Stats. 3620	July 1, 1914
Oregon	Or. C., Sec. 61-211 212	June 16, 1913
Pennsylvania	Sec. 1404, Art. V, P. U. Law	November 19, 1911
Rhode Island	Sec. 58, Ch. 253, G. L. 1923	January 1, 1937
South Carolina	Sec. 2 (a), 1932 Reg. Act.	January 1, 1931
Tennessee	Sec. 5451, Tenn. Code	December 28, 1922
Utah	Sec. 76-4-22, R. S.	December 26, 1922
Vermont	Sec. 6096, P. L. of Vt.	May 27, 1929
Virginia	Sec. 4070, Va. Code	December 11, 1920
Washington	Sec. 2, Ch. 151, L. 1933	January 29, 1913
West Virginia	Sec. 8, Art. 2, Ch. 24, Code of W. Virginia	March 6, 1923
Wisconsin	Sec. 196.06, Wise. Stats	December 15, 1940
Wyoming	Sec. 94-144, R. S. 1931	March 13 ¹ 1923

The following States have no such statute:

Delaware ¹

Florida ²

Iowa ³

Minnesota ²

Mississippi ²

South Dakota ²

Texas ²

¹ Delaware has no regulatory commission.

² Regulatory Commission of this State has no jurisdiction over electric or gas utilities.

³ Regulatory Commission of this State has no jurisdiction over valuation or rates of electric utilities.